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Deductibility of Loan Origination Costs

ALAN B. ROSENTHAL†

INTRODUCTION

As of March 31, 1993, U.S. commercial banks had lent over \$1.8 trillion to domestic borrowers.¹ Prior to making a loan, banks incur certain expenses connected with the loan, including underwriting, marketing, and administrative costs. Such expenses are commonly referred to as loan origination costs. A debate rages over whether loan origination costs should be deducted as ordinary and necessary business expenses or capitalized over the life of the loan.

Neither the Internal Revenue Service ("Service") nor any court has ruled on this issue.² Although lenders have long deducted loan origination costs without Service opposition, Service Field Agents ("Agents") conducting bank audits have recently taken the position that loan origination costs are not deductible because they are incurred to purchase a capital asset (a loan) and therefore should be capitalized and amortized over the life of the outstanding loan.³

The American Banking Association ("ABA"), the national trade and professional association of U.S. commercial banks,⁴ opposes the Agents' position.⁵ The ABA argues that the costs of originating a loan should be deducted, not capitalized, because they are ordinary and necessary business expenses.⁶

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1. Henry Ruempler & Paul V. Salfi, *Tax Treatment of Loan Origination Costs and Fees*, 60 TAX NOTES 1745, 1746 (1993).

2. The Service had promised to issue guidance before the end of 1993. [60 Taxes] Banking Rep. (BNA) No. 20, at 706 (May 17, 1993). However, none has yet issued. If ever issued, such guidance is likely to have prospective effect only. *Id.*

3. The Service's position, as presented herein, is derived primarily from Ruempler & Salfi, *supra* note 1, and John J. Andaloro & John W. Alexander, *IRS Fails to Consider Loan Origination Costs in Overall Business Context*, 6 J. BANK TAX'N, Winter 1993, at 7.

4. Banks of all types and sizes—money center, regional, and community banks—are members of the ABA. The assets of ABA member banks represent about ninety percent of U.S. bank assets. Letter from Henry Ruempler, Director of Tax and Accounting for the American Banking Association, to Abraham N.M. Shashy, Jr., Chief Counsel of the Internal Revenue Service (Oct. 2, 1992) (on file with author).

5. I take the ABA's position as articulated in Ruempler & Salfi, *supra* note 1. Ruempler and Salfi are, respectively, ABA Director of Tax and Accounting, and ABA Financial Analyst. *Id.*

6. *See id.* at 1745-46.

The controversy over deduction versus capitalization of loan origination costs has arisen because of the inherent benefit to taxpayers of deducting, rather than capitalizing, an outlay. By deduction, the cost incurred offsets current income. Non-deductible outlays are capitalized, and then either amortized or depreciated over the life of the relevant asset, set-off against gain on its eventual sale or disposition, or, where no specific asset or useful life can be ascertained, deducted upon dissolution of the enterprise.⁷ As the Supreme Court has declared, the purpose of capitalization is "to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."⁸ Therefore, the capitalization requirement, coupled with amortization, functions to "avoid distortion of income."⁹ If banks are allowed to offset business outlays against income sooner or later, why the controversy? Because current deduction of loan origination costs is much more valuable to a taxpayer bank (and thus equally costly to the U.S. Government) than capitalization and amortization of such costs over the loan's life.¹⁰

This Comment examines the debate over the tax treatment of loan origination costs. Part I presents a brief overview and description of the banking process and the nature of loan origination costs, including a listing of the many types of costs that are incurred by a bank prior to making a loan.

Part II analyzes the relevant sections of the Internal Revenue Code ("Code") upon which the Agents and the ABA base their arguments. The Agents propose applying section 263(a) of the Code,¹¹ which disallows deduction of capital expenditures.¹² The ABA argues for the application of Code section 162,¹³ which allows deduction of certain trade or business expenses.¹⁴ Part II will also

7. *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. 1039, 1042-43 (1992).

8. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

9. John W. Lee, *Doping Out The Capitalization Rules After Indopco*, 57 TAX NOTES 669, 670 (1992).

10. This theory is based on the time value of money, *i.e.*, a dollar today is more valuable than the promise of a dollar to be received in the future. Simply put, a current deduction reduces a taxpayer's taxes this year, leaving him more money to invest this year. Being forced to refrain from offsetting income until the future means higher current taxes to the taxpayer, thus leaving him unable to invest the money he would have retained if current deduction had been allowed. See Note, *Fairness and Tax Avoidance in the Taxation of Installment Sales*, 100 HARV. L. REV. 403, 403 n.5 (1986).

11. Ruempler & Salfi, *supra* note 1, at 1746.

12. I.R.C. § 263(a) (1988).

13. Ruempler & Salfi, *supra* note 1, at 1746.

14. I.R.C. § 162 (1988) (allowing a deduction for all of the ordinary and necessary expenses incurred during the taxable year in carrying on any trade or business).

examine the regulations promulgated under the Code by the Secretary of the Treasury Department.¹⁵

Part III compares and contrasts the arguments for and against deducting loan origination costs. The authorities the Agents and the banks rely on include the United States Supreme Court decisions in *INDOPCO, Inc. v. Commissioner*,¹⁶ *Commissioner v. Lincoln Savings & Loan Association*,¹⁷ and *Commissioner v. Idaho Power Co.*;¹⁸ a 10th Circuit Court of Appeals decision in *Colorado Springs National Bank v. United States*;¹⁹ Code sections 263A²⁰ and 195;²¹ Revenue Ruling 92-80;²² and the accounting standards set out in the Statement of the Financial Accounting Standards No. 91.²³

Finally, this Comment concludes with a discussion of what tax consequences a bank can reasonably anticipate based on recent Service actions and the trend in the law.²⁴

I. BANKING AND LOAN ORIGINATION COSTS

One of a bank's major objectives is to lend money at an interest rate spread that covers the costs of intermediation and earns a return for the bank's shareholders.²⁵ Lending is viewed as one of a bank's major roles. Federal and state bank regulators and bank analysts measure bank performance and condition largely by analyzing loan portfolios,²⁶ and the Internal Revenue Code's definition of a bank includes "making loans" among three functions comprising a substantial part of a bank's business.²⁷

The loan origination process is essentially the same for all consumer, real estate, and commercial loans. Banks incur expenses

15. The Code grants authority to the Treasury Secretary to "prescribe all needful rules and regulations for the enforcement of [the Code]." I.R.C. § 7805(a) (1988).

16. 112 S. Ct. 1039 (1992); see *infra* part III.A.

17. 403 U.S. 345 (1971); see *infra* part III.B.

18. 418 U.S. 1 (1974); see *infra* part III.C.

19. 505 F.2d 1185 (10th Cir. 1974); see *infra* part III.D.

20. I.R.C. § 263A (1988) (requiring direct costs and proportionate share of indirect costs of property to be capitalized); see *infra* part III.E.

21. I.R.C. § 195 (1988) (stating that no deduction is allowed for a start-up expenditure); see *infra* part III.F.

22. Rev. Rul. 92-80, 1992-2 C.B. 465; see *infra* part III.G.

23. ACCOUNTING FOR NONREFUNDABLE FEES AND COSTS ASSOCIATED WITH ORIGINATING OR ACQUIRING LOANS AND INITIAL DIRECT COSTS OF LEASES, Statement of Financial Accounting Standards No. 91 (Fin. Accounting Standards Bd. 1986) [hereinafter SFAS 91]; see *infra* part III.H.

24. See *infra* part IV.

25. Ruempler & Salfi, *supra* note 1, at 1746.

26. *Id.*

27. I.R.C. § 581 (1988).

which are incorporated into loan pricing strategies and customer profitability analyses.²⁸ Loan origination expenses are common to all banks, and normally recur during the life of a loan.²⁹ Furthermore, the particular expenses incurred are specific to each and every loan recipient. The loan origination process can be divided into six stages:

1. Proposal: Outlining potential terms for a borrower, including the costs of structuring a loan, and then making a tentative agreement with the borrower;

2. Underwriting: Evaluating the credit worthiness of the borrower by completing a credit analysis and a collateral appraisal, as well as by determining the borrower's strength based on her cash flow and financial condition;

3. Approval: Granting the bank's commitment to make a loan after evaluating whether the loan request meets the profitability requirements of the bank and based on the information about the borrower gathered during the underwriting stage;

4. Settlement: Agreement between the lender and the borrower after negotiating the detailed terms, the approved conditions of the loan, and the documentation of the transaction;

5. Funding: Disbursing the loan proceeds in accordance with the loan documentation;

6. Post-funding: Although this stage marks the end of the loan origination process, additional marketing, underwriting, appraisal, legal, and administrative expenses will be incurred throughout the life of the loan to secure the continuity of both the loan's value and the relationship with the borrower.³⁰

The six stages in the loan origination process summarize how a bank incurs loan origination costs. The rest of this comment explores how these costs should be treated under the tax code.

II. INTERNAL REVENUE CODE

The question of what is the proper tax treatment of loan origination costs, deduction or capitalization, arises under Code section 161. Section 161 is entitled "Allowance of Deductions" and provides that "[i]n computing taxable income . . . there shall be allowed as deductions the items specified in this part [including section 162(a)], subject to the exceptions provided in part IX (sec. 261 and following [including section 263] relating to items not deducti-

28. Ruempler & Salfi, *supra* note 1, at 1750.

29. *Id.*

30. *Id.* at 1750-52.

ble).”³¹ Thus, section 161 requires a determination whether loan origination costs should be subject to section 162(a), allowing the deduction of ordinary and necessary trade or business expenses, or section 263(a), disallowing deduction of capital expenditures.³²

The two Code sections at issue, sections 162 and 263(a), provide taxpayers with two methods to offset expenses against income. Which method applies depends on what, why, and how the expenses were initially incurred. Section 162(a) provides that “[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”³³ Section 263 provides that “no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate,” commonly termed capital expenditures.³⁴ These two sections thus comprise the framework for determining whether or not expenses are deductible.

Thus, by enacting these two sections, Congress (1) allowed the deduction from the current year’s income of all ordinary and necessary business expenditures, and (2) required capital expenditures to be capitalized and properly matched against the income they generate through amortization or depreciation over the capital asset’s estimated useful life.³⁵ However, Congress’ wording fails to

31. I.R.C. § 161 (1988).

32. *Id.* §§ 162(a), 263(a).

33. *Id.* § 162(a). The Supreme Court has explained and defined the meaning of these words. *See infra* part III.B.

34. I.R.C. § 263(a)(1) (1988). Section 263 contains several specific exceptions to the general rule. However, these exceptions do not apply to loan origination costs. These exceptions include:

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) expenditures by farmers for fertilizer, etc. deductible under section 180,

(E) expenditures for removal of architectural and transportation barriers to the handicapped and elderly which the taxpayer elects to deduct under section 190,

(F) expenditures for tertiary injectants with respect to which a deduction is allowed under section 193; or

(G) expenditures for which a deduction is allowed under section 179.

Id. § 263(a)(1)(A)-(G).

35. Bryan Mattingly, *INDOPCO, Inc. v. Commissioner: Will the IRS Use a Nebulous Supreme Court Decision to Capitalize on Unsuspecting Taxpayers?*, 81 Ky. L.J. 801, 806 (1992); *see* Thomas F. Quinn, *Takeover Expenses Incurred by the Acquired Corporation—Not Just An Ordinary Deduction: National Starch & Chemical Corp. v. Commissioner*, 10 J. L. & Com. 167, 169 (1990). The difference between amortization and depreciation has been described as follows:

Amortization describes loss in value due to the passage of time. Depreciation

clearly demarcate between deductible and nondeductible outlays. The Treasury Regulations provide some further guidance. Regulation § 1.263(a)-2(a) provides an example of a capital expenditure: "The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year."³⁶ It has generally been held that section 263(a) applies to an expenditure if it creates or enhances or is part of the cost of an asset that has a useful life greater than one year and thus prevents the application of section 162 to such an expenditure.³⁷ Regulation § 1.461-1(a)(2) provides some further elucidation: "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made."³⁸

The courts and the Internal Revenue Service have further elaborated upon the determination whether an expense should be deducted or capitalized.

III. INTERNAL REVENUE SERVICE FIELD AGENTS v. AMERICAN BANKING ASSOCIATION

A. INDOPCO, Inc. v. Commissioner

The leading and most recent case cited by the IRS Agents in support of their position to capitalize loan origination costs is *INDOPCO, Inc. v. Commissioner*.³⁹ In *INDOPCO*, a unanimous Supreme Court restated the "'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of

refers to the gradual reduction in value of property because of physical deterioration through use. A taxpayer generally amortizes intangible assets and depreciates tangible assets. For example, the taxpayer amortizes the cost of prepaid expense payments, such as advance rental payments, over the useful life of the payments. In the case of tangible assets the taxpayer depreciates the cost over the useful life of the asset.

Id. at 169 n.14 (citations omitted).

36. Treas. Reg. § 1.263(a)-2(a) (as amended in 1987).

37. See *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181 (5th Cir. 1984); *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*, 393 F.2d 494 (4th Cir.), cert. denied, 393 U.S. 962 (1968); *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), vacated on other grounds, 382 U.S. 68, original holding on this issue reaff'd, 354 F.2d 410 (4th Cir. 1965); *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985); *Florida Publishing Co. v. Commissioner*, 64 T.C. 269 (1975), aff'd by unpublished opinion, 552 F.2d 367 (5th Cir. 1977).

38. Treas. Reg. § 1.461-1(a)(2) (as amended in 1992).

39. 112 S. Ct. 1039 (1992). See *Andaloro & Alexander*, *supra* note 3, at 8; *Ruempler & Salfi*, *supra* note 1, at 1746.

clearly showing the right to the claimed deduction is on the taxpayer.’”⁴⁰ Additionally, the Court observed that the language of Code sections 162 and 263 support the notion that deductions are exceptions to the norm of capitalization.⁴¹ Under *INDOPCO*, therefore, the burden of proving that loan origination costs are deductible falls squarely on the shoulders of the lender.

INDOPCO did not involve loan origination costs, but, instead, professional expenses incurred by a target corporation in a friendly takeover.⁴² Discussing sections 162(a) and 263 of the Code, the Court pronounced, based on previous Supreme Court decisions, that one section must be construed in light of the other.⁴³ As originally stated in *Commissioner v. Lincoln Savings*,

[d]eductions are specifically enumerated [in the Code] and thus are subject to disallowance in favor of capitalization. See §§ 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a “complete list of nondeductible expenditures,” *Lincoln Savings*, § 263 serves as a general means of distinguishing capital expenditures from current expenses.⁴⁴

Thus, the Court held that, in enacting these sections, Congress specified the exclusive list of deductible expenses. Based on this reasoning, loan origination costs are not deductible because the Code does not so specify.

The *INDOPCO* Court employed a “useful life of the expense” analysis to determine whether the expenses should be deducted or capitalized: “Although the mere presence of an incidental future benefit—*some* future benefit—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.”⁴⁵ This test relates to Congress’ purpose to match expenses with the revenues of the taxable period to which they are

40. *INDOPCO*, 112 S. Ct. at 1043 (quoting *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943)). See also *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

41. *INDOPCO*, 112 S. Ct. at 1042-43.

42. *Id.* at 1041. *INDOPCO* involved a friendly acquisition that changed a publicly held, freestanding corporation into a wholly owned subsidiary. *Id.* The professional expenses consisted of investment bank underwriting, accounting, printing, proxy solicitation, and legal fees associated with a takeover. *Id.* at 1042.

43. *Id.* at 1043 & n.5 (listing cases).

44. *Id.* at 1043 (citation omitted) (quoting *Commissioner v. Lincoln Sav. & Loan Ass’n*, 403 U.S. 345, 358 (1971)).

45. *Id.* at 1044-45. See also *United States v. Mississippi Chem. Corp.*, 405 U.S. 298, 310 (1972); *Central Tex. Sav. & Loan Ass’n v. United States*, 731 F.2d 1181, 1183 (5th Cir. 1984).

properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.⁴⁶ Furthermore, the *INDOPCO* Court stated that "the text of the Code's capitalization provision, § 263(a)(1), which refers to 'permanent improvements or betterments,' itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer."⁴⁷

The *INDOPCO* Court concluded that the transaction produced significant benefits to the taxpayer which extended beyond the tax year in question. Because the acquiring corporation benefitted from the availability of the target's enormous resources over many years, the Court held that the expenses should be capitalized rather than deducted in the current taxable year.⁴⁸

The benefit of having a loan outstanding for a term of more than one year is an important goal of the banking industry. The Agents might be expected to argue that this fact should be accorded great weight for purposes of determining the "useful life" of the asset created or enhanced by loan origination costs. Accordingly, the costs incurred to make loans would be amortized over the time period during which the banks benefit from them, i.e., over the term of the loan. Thus, based on the reasoning of the Supreme Court in *INDOPCO*, the Agents could argue that the costs incurred to eventually receive the loan's benefits should be capitalized because such benefits extend well past the current deducting year.

The ABA contends that the Supreme Court's decision in *INDOPCO* is not an authority for the capitalization of loan origination costs.⁴⁹ Instead, they argue that the Agents mistakenly attempt to apply the dicta from this decision.⁵⁰ The main thrust of the ABA's argument is that the case of loan origination costs and *INDOPCO* are factually distinguishable.⁵¹ The banks further claim that the loan origination process is an ordinary and necessary undertaking which does not result in the same type of long-term benefit that resulted from the corporate restructuring in *INDOPCO*.⁵² Thus, a one-time expenditure in connection with a corporate takeover is very different from the loan origination expenses that con-

46. See, e.g., *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), cert. denied, 463 U.S. 1207 (1983).

47. *INDOPCO*, 112 S. Ct. at 1045.

48. *Id.* at 1045-46.

49. *Ruempler & Salfi*, *supra* note 1, at 1746.

50. See *id.*

51. See *id.*

52. *Id.*

tinually recur in the banking business.⁵³

The ABA argues that the Court's *INDOPCO* ruling was based upon a long-recognized practice of capitalizing an expenditure incurred in connection with a change in corporate structure, and thus did not signify a new general rule of law for determining whether an expenditure must be capitalized.⁵⁴ Although the opinion stated that the Code itself, under section 263(a)(1), "envisions an inquiry into the duration and extent of the benefits realized by the taxpayer,"⁵⁵ and that "some future aspect" is undeniably important, the Court added that such future aspect "is not necessarily controlling."⁵⁶ This, the banks could argue, limited the Court's holding, and so the ruling did not decide that every expense devoted to income production or any other need of an ongoing business must be capitalized.⁵⁷ Thus, it would be expected that the ABA would propose that *INDOPCO* did not change the law to require capitalization of loan origination costs. Instead, *INDOPCO* furthered the long-standing, narrow rule that capitalization is required only if the expense was incurred in connection with a corporate restructuring.

The argument that *INDOPCO* should be limited to its facts appears unwarranted. Based on its holding in *Lincoln Savings*, the *INDOPCO* Court articulated a general analysis of the Code's requirements as to deduction versus capitalization, i.e., as to sections 162 and 263(a). None of these authorities solely revolve around corporate restructurings. On the contrary, much of the *INDOPCO* Court's discussion was of a general nature, thus implying its applicability beyond the corporate restructure context.

B. Commissioner v. Lincoln Savings & Loan Association

The test to determine whether an expense is currently deductible was originally articulated in *Commissioner v. Lincoln Savings & Loan Association*.⁵⁸ There the Court decided that an expense is not ordinary if it is made in an attempt to create a "separate and distinct asset."⁵⁹ The Agents rely on this decision, arguing that

53. *Id.* at 1747.

54. *Id.* at 1746.

55. *INDOPCO*, 112 S. Ct. at 1045.

56. *Id.* at 1044-45.

57. The Court in *INDOPCO* cited *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964), for the proposition that an expense incurred to change the corporate structure for the future is not a deductible ordinary and necessary business expense.

58. 403 U.S. 345 (1971).

59. *Id.* at 354.

each loan is a separate and distinct asset, and, therefore, the costs incurred to create each loan are part and parcel of the loan and must be capitalized.⁶⁰

Lincoln Savings determined whether a savings and loan institution, under the National Housing Act,⁶¹ could deduct, pursuant to Code section 162(a), an additional insurance premium.⁶² Relying on precedent, the Court articulated the following test: "To qualify as an allowable deduction under Section 162(a) . . . an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense."⁶³

The Court in *Lincoln Savings* was only concerned with one of the test's five requirements. The Court was satisfied that the first four requirements had been met because the premium was definitely a necessary expense that was incurred in the taxable year in carrying on a trade or business.⁶⁴ Therefore, all that remained to be decided was whether the expense was ordinary. The majority decided that the expense was not ordinary because it was a

payment that serve[d] to create or enhance . . . what [was] essentially a separate and distinct additional asset and that, as an inevitable conse-

60. See Andalora & Alexander, *supra* note 3, at 8; Ruempler & Salfi, *supra* note 1, at 1745. Although the Court in *INDOPCO* modified the separate and distinct asset test, the *Lincoln Savings* analysis is still useful for determining whether an expense falls under section 162(a).

61. National Housing Act § 404(d), as amended, 75 Stat. 482, 483-84 (1961) (repealed 1989).

62. *Lincoln Savings*, 403 U.S. at 345. Section 404(d) provided as follows:

Each insured institution . . . shall annually pay to the Corporation, at such time and in such manner as the Corporation shall by regulations or otherwise prescribe, an additional premium in the nature of a prepayment with respect to future premiums of such institution . . . equal to 2 per centum of the net increase in all accounts of its insured members . . . for the purchase of stock of the Federal Home Loan Bank of which such institution is a member

75 Stat. 482, 483-84 (1961) (repealed 1989).

63. *Lincoln Savings*, 403 U.S. at 352 (quoting I.R.C. § 162(a)). The *Lincoln Savings* Court cited Justice Cardozo's opinion in *Welch v. Helvering*, 290 U.S. 111 (1933), to emphasize the difference between "ordinary" and "necessary" and the requirement that both must be satisfied to allow a deduction under Section 162(a). *Id.* at 115. The *Lincoln Savings* Court further cited two other Supreme Court opinions to expand upon Justice Cardozo's explanation. Justice Douglas in *Deputy v. Du Pont*, 308 U.S. 488 (1940), explained that "the term [ordinary] ordinarily has the connotation of normal, usual, or customary." *Id.* at 495-96. And Justice Stewart, in *Commissioner v. Tellier*, 383 U.S. 687 (1966), stated that "[t]he principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset." *Id.* at 689-90.

64. *Lincoln Savings*, 403 U.S. at 354.

quence, the payment [was] capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a) in the absence of other factors not established here.⁶⁵

The Agents might conclude that loan origination costs can be viewed as creating a separate and distinct asset. They would probably argue that, although four of the five requirements of the *Lincoln Savings* test are met, the ordinary expense branch is not satisfied under *Lincoln Savings*; therefore, no deduction may be allowed. They could further argue that the lack of explicit mention of loan origination costs or additional premium costs in section 263(a)'s list of nondeductible capital expenditures is unimportant because it is clear from the very language of sections 162 and 263(a) that the two sections together were not intended to provide all-inclusive listings.⁶⁶

C. Commissioner v. Idaho Power Co.

The Agents also base their argument to capitalize loan origination costs on *Commissioner v. Idaho Power Co.*⁶⁷ In *Idaho Power*, the Court reasoned that if an asset is consumed over a period longer than one year, it is a capital asset and, correspondingly, over that period, its theoretical value and utility become reduced.⁶⁸ The *Idaho Power* Court explained the difference between an asset that would be "used up" in the present year and one which would have a significant life beyond the year in question:

When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of income. . . . It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. . . . [T]he cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.⁶⁹

The Court endeavored to treat an expense in "a manner that com-

65. *Id.*

66. *Iowa S. Utils. Co. v. Commissioner*, 333 F.2d 382, 385 (8th Cir.), *cert. denied*, 379 U.S. 946 (1964); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 716 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964); *see United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Woodward v. Commissioner*, 397 U.S. 572 (1970); *Helvering v. Winnill*, 305 U.S. 79 (1938).

67. 418 U.S. 1 (1974). *See Ruempler & Salfi*, *supra* note 1, at 1746.

68. *Idaho Power*, 418 U.S. at 10.

69. *Id.* at 11.

ports with accounting and taxation realities."⁷⁰ The Court noted that "accepted accounting practice and established tax principles require the capitalization of the cost of acquiring a capital asset."⁷¹ Additionally, the Court observed that "[i]t has long been recognized, as a general matter, that costs incurred in the acquisition . . . of a capital asset are to be treated as capital expenditures."⁷²

Although the Court appeared to have decided that the costs of creating a capital asset are to be capitalized, it went on to discuss section 263's purpose "to reflect the basic principle that a capital expenditure may not be deducted from current income."⁷³ Thus, the *Idaho Power* Court's reasoning is based on the principle that capitalization "serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."⁷⁴

The Agents might be expected to argue that the costs incurred by a bank to make a loan are analogous to the costs incurred in *Idaho Power*. Clearly, they both involve expenses that create an asset which will be in existence beyond the current taxable year. The Court stated that the time frame for taxing the costs should relate to when the benefits will be received. Therefore, the loan origination costs, under a highly plausible Agents' theory, should be capitalized over the life of the asset they are creating, i.e., until the entire loan is repaid.

The *Idaho Power* Court did not seem to rely on the separate and distinct asset test of *Lincoln Savings*. Instead, it attacked the issue from the standpoint of whether the asset could be used up in the single year in which the expenses were incurred to create it. The Court wanted to avoid allowing a deduction for a cost that will provide a future benefit.

Both sides admit that normally a loan has a life beyond the current taxable year. Therefore, even if it were conceded that the *Lincoln Savings* "separate and distinct asset" test does not apply to loan origination costs, under *Idaho Power*, they must be capitalized because they are incurred to create loans from which benefit is

70. In *Idaho Power*, the respondent, a public utility, had claimed a depreciation deduction on its federal income tax return for all of its transportation equipment, including that equipment which was used to construct capital facilities having a useful life greater than one year. However, on its books, the taxpayer, as required by the regulatory agencies, had charged these expenses to capital assets that were used in construction. *Id.* at 5.

71. *Id.* at 12; see *infra* part III.H.

72. *Idaho Power*, 418 U.S. at 12 (quoting *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970)).

73. *Id.* at 16.

74. *Id.*

derived beyond the taxable year.⁷⁵

D. Colorado Springs National Bank v. United States

The ABA attempts to rebut the argument made by the Agents for capitalization based on *Colorado Springs National Bank v. United States*.⁷⁶ In *Colorado Springs*, the Tenth Circuit disagreed with the Government's contention that a bank's new credit card system was a "separate and distinct asset" requiring capitalization. The court held for the taxpayer bank that it could deduct all of the computer, advertising, clerical, education, and start-up costs associated with setting up a credit card system.⁷⁷ Based on the reasoning in *Colorado Springs*, the banks argue that a loan is not a separate and distinct asset, either.⁷⁸

The *Colorado Springs* court found that "[t]he credit card system enable[d] a bank to carry on an old business in a new way,"⁷⁹ and a new method of conducting old business is definitely distinguishable from a new business.⁸⁰ The court concluded that an extension of credit which required both a risk evaluation and a credit investigation were new methods of conducting an old business.⁸¹ What the taxpayer had done was determine the risk involved in

75. The Service continued the *Idaho Power* Court's line of reasoning in Tech. Adv. Mem. 90-24-003 (March 2, 1990). The specific issue in TAM 90-24-003 was whether a savings bank should be allowed to deduct, under Code § 162, amounts paid to establish a home equity line of credit (HELOC). The Service concluded that because HELOC loans have a useful life that extends beyond the current taxable year, the costs incurred to create or acquire them must be capitalized pursuant to § 263(a) of the Code. Therefore, the Service would argue, in respect of loan origination costs, the burden is on the lending institutions to prove that the useful life of their loan is less than one year in order to be able to deduct these expenses.

In rebuttal, the ABA could argue that caselaw presents no such bright line test to determine deductibility. See James D. Goeller, *Will Accounting Rules Bar Deductibility of Loan Origination Costs?*, 6 J. BANK TAX'N 8 (1993).

One commentator has stated that this TAM, in essence, suggests that the "IRS is attempting to lay the groundwork to support [the capitalization of] all loan origination or acquisition costs." W. Michael Bryant, *Costs Incurred to Create or Acquire Loans Must be Capitalized*, TAX ADVISER, Feb. 1991, at 96. See also *Bonded Mortgage Co. v. Commissioner*, 27 B.T.A. 965, 971 (1933), *aff'd in part and rev'd in part*, 70 F.2d 341 (4th Cir. 1934).

76. 505 F.2d 1185 (10th Cir. 1974). See Ruempler & Salfi, *supra* note 1, at 1748.

77. *Colorado Springs*, 505 F.2d at 1187. In *Colorado Springs*, the taxpayer was a full service, national bank. The bank acquired the right to use the Master Charge credit card system in late 1968 and thus started the use of Master Charge in the State of Colorado. The taxpayer deducted its start-up expenses as business expenses. *Id.*

78. Ruempler & Salfi, *supra* note 1, at 1748.

79. *Colorado Springs*, 505 F.2d at 1190.

80. *Id.*; see *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated on other grounds*, 382 U.S. 68 (1965).

81. *Colorado Springs*, 505 F.2d at 1190.

the issuance of the credit card; and “[s]uch risk determination [was both] appropriate and useful to development of taxpayer’s banking business.”⁸² Based upon this reasoning, the court allowed deduction of the credit card system start-up costs.

The banks may argue that loan origination costs warrant the same tax treatment as the start-up costs in *Colorado Springs*, because they are both incurred to carry on an old business of banking in a new way.⁸³ Therefore, the costs incurred to make a loan would thus be deducted in the same way that the costs to set up a credit card system were deducted.

Colorado Springs appears to be inapplicable to loan origination costs because of a fundamental difference between a credit card system and a loan. A credit card system has no determinable useful life. Loans, by contrast, have definite useful lives, over which their origination costs can be amortized.

Colorado Springs is the only case the banks can offer to support their position. Without more, the banks appear to face a steep uphill battle. After all, *Lincoln Savings*, which disallowed the deduction of loan insurance premiums, appears just as applicable (or inapplicable) to loan origination costs as *Colorado Springs*. In other words, *Colorado Springs*, on its own and without further support, does not appear to constitute precedent for allowing deduction of loan origination costs. The Agents, in contrast, do not base their reliance on a single case. To bolster their analysis, they cite three Supreme Court decisions: *Idaho Power*, *Lincoln Savings*, and *INDOPCO*.

E. Section 263A and Notice 88-86

In *INDOPCO*, the Court read Code section 162 narrowly, while reading the capitalization section, section 263(a), as the all-encompassing way to treat expenses that do not fit into the narrow section 162 mold.⁸⁴ Thus, the Court concluded that the debate centers around two sections, 162 and 263(a). However, the banks have attempted to bring a third section into the picture.⁸⁵ They have relied on section 263A to show that loan origination costs do not have to be capitalized.

Congress enacted the uniform capitalization rules of Code section 263A⁸⁶ to alleviate problems caused by section 263(a). Section

82. *Id.* at 1191.

83. See Ruempler & Salfi, *supra* note 1, at 1748.

84. See *supra* part III.A.

85. Ruempler & Salfi, *supra* note 1, at 1747.

86. Section 263A states:

263A was an attempt to simplify the multiple sets of rules on capitalization and to make a "single, comprehensive set of rules . . . [to] govern the capitalization of costs of producing, acquiring and holding property, including interest expense."⁸⁷ Following this enactment, many commentators believed that loan origination costs would be required to be capitalized under this section.⁸⁸ However, in Notice 88-86, the IRS stated:

[T]he origination of a loan shall be treated under Section 263A as the production of intangible property as opposed to the acquisition of intangible property for resale. Thus the capitalization rules of Section 263A shall not apply to such activity, because Section 263A only applies to the production of tangible personal property. Section 263A, however applies to taxpayers purchasing pre-existing loans from other parties for resale. Such taxpayers are treated as acquiring intangible property for resale, and hence, are subject to the uniform capitalization rules. The provisions of this paragraph apply only for purposes of Section 263A and no inference relating to the treatment of such property for other purposes of the Code is intended.⁸⁹

The banks would probably rely on this Notice to show that loan origination costs should not be capitalized under section 263A. However, the *INDOPCO* Court, by not even mentioning section 263A, decided by clear implication that 263A is inapplicable to the question whether an expenditure is deductible or not.

F. Section 195

Section 195 of the Code, which provides for the deductibility of certain business start-up expenditures, can be cited by both sides to support their positions on the taxation of loan origination costs.⁹⁰ A start-up cost is a cost incurred by a taxpayer subsequent

(a) Nondeductibility of certain direct and indirect costs.—

(1) In general.— In the case of any property to which this section applies . . .

(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

(B) in the case of any other property, shall be capitalized.

. . . .

(b) Property to which section applies.— Except as otherwise provided in this section, this section shall apply to—

(1) Property produced by taxpayer.— Real or tangible personal property produced by the taxpayer.

(2) Property acquired for resale. . . .

I.R.C. § 263A(a)-(b) (1988).

87. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 508-09 (1987). See Treas. Reg. § 1.263A-1(a) (1986).

88. Goeller, *supra* note 75, at 5.

89. I.R.S. Notice 88-86, 1988-2 C.B. 401.

90. I.R.C. § 195 (1988).

to a decision to open a particular business but prior to its actual operation.⁹¹ The general rule of section 195(a) is that "except as otherwise provided . . . no deduction shall be allowed for start-up expenditures."⁹² By enacting section 195, Congress permitted taxpayers to elect to prorate a deduction for allowed start-up expenditures over a period of not less than sixty months.⁹³

Section 195 codified the "pre-opening expense doctrine."⁹⁴ The doctrine holds that costs incurred to create a new trade or business must be capitalized because (1) section 162 does not apply until the trade or business begins and (2) the costs of starting a new trade or business are incurred to create an asset with a useful life extending beyond the current taxable year.⁹⁵

The language of section 195 makes it clear that expansion costs of an existing business are not eligible for amortization: they must be either deducted under section 162 or capitalized under section 263. The Agents would be expected to cite *INDOPCO* for the proposition that expansion costs in an existing business are not deductible. Thus, they would argue, *INDOPCO* and section 195 together require that an existing business' expansion costs are both nondeductible (under *INDOPCO*) and non-amortizable (under section 195).⁹⁶ The Agents, in other words, would argue that loan origination costs are neither deductible nor amortizable over sixty months, but rather must be capitalized.

91. Specifically, the Internal Revenue Code defines the term "start-up expenditure" to mean any amount—

(A) paid or incurred in connection with—

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

Id. § 195(c)(1).

92. *Id.* § 195(a).

93. Section 195(b) states: "Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer . . ." *Id.* § 195(b).

94. George B. Javaras & Todd F. Maynes, *Business Expansion and Protection in the Post-INDOPCO World*, 55 *TAX NOTES* 971, 974 (1992).

95. *Id.*; see *Richmond Television Corp. v. United States*, 345 F.2d 901 (4th Cir.), *vacated on other grounds*, 382 U.S. 68, *original holding on this issue reaff'd*, 354 F.2d 410 (4th Cir. 1965).

96. Mattingly, *supra* note 35, at 820.

The banks might also cite section 195 to bolster their argument for deductibility. Congress, they could argue, created section 195 to allow start-up expenditures to be amortized over sixty months, if such expenditures would have been deductible in an existing business. If, as the Agents would contend, expansion costs were not deductible for an existing business, "section 195 would be useless because no start-up expenditure could satisfy the 'otherwise deductible as a business expansion expenditure' requirement."⁹⁷ Therefore, the banks would contend, expansion expenses, of which loan origination costs are a variety, are eligible for deduction.

This argument assumes that loan origination costs are expansion costs as were the costs of setting-up a credit card system in *Colorado Springs*. In the unlikely event that loan origination costs are deemed start-up expenditures,⁹⁸ section 195 would require their amortization over sixty months and thus prevent their current deduction. Finally, section 195 may refer to expenses, such as advertising and other selling expenses, that are specifically recognized exceptions to the capitalization requirement. Thus, it may well be incorrect to read section 195 to broaden its own applicability by transforming otherwise nondeductible expenses into deductible expenses.

G. Revenue Ruling 92-80

The ABA would be expected to cite Revenue Ruling 92-80⁹⁹ to demonstrate that loan origination costs should be deductible. The question there presented to the IRS was whether the Supreme Court's decision in *INDOPCO* affected the treatment of advertising costs. Generally, advertising costs had been deductible. Indeed, Regulation § 1.162-1(a) provides that "advertising and other selling expenses" are among the deductible business expenses under Code section 162.¹⁰⁰ The Service ruled that the *INDOPCO* decision did not affect the treatment of advertising costs under section 162(a) even though such expenditures provided some future benefit to the business incurring the expense.¹⁰¹

97. *Id.*; see *Do Briarcliff Candy and Code Section 195 Stiff National Starch?*, 49 Tax Notes 1223-29 (1990).

98. *Cf. Cottage Sav. Ass'n v. Commissioner*, 499 U.S. 554 (1991) (holding that an entity is materially different if each embodies a legally distinct entitlement). The banks could argue, albeit tenuously, that each loan can be considered a separate entity because each has its unique borrower, interest rate, and risk.

99. Rev. Rul. 92-80, 1992-2 C.B. 57.

100. Treas. Reg. § 1.162-1(a) (as amended in 1988).

101. Rev. Rul. 92-80, 1992-2 C.B. 57.

After ruling in Revenue Ruling 92-80 that the costs of advertising are deductible, the Service did not end its discussion. It further stated that "[o]nly 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 the advertising be capitalized by the lending institutions."¹⁰² It appears reasonable to infer from the Service's language here that if the future benefit is only a secondary or incidental purpose of the advertising expenditure, a current deduction is allowed.¹⁰³ The banks might thus rely on this Ruling to show that loan origination costs are only an incidental expense in the lending process and, as such, should be deductible as are advertising costs.

The banks would probably argue that if the Service has allowed the continued deductibility of advertising expenses following the decision in *INDOPCO*, then it should also allow the continued deductibility of loan origination costs. Both are recurring expenses incurred in a trade or business, and both confer benefits to the taxpayer beyond the current year.

The Agents could respond that Revenue Ruling 92-80 is completely in line with *INDOPCO* because advertising is a specifically enumerated expense that may be deducted currently under Regulation § 1.162-1(a). Loan origination costs are not; nor are they so similar in nature to advertising costs that rules covering advertising costs should necessarily be applied to also cover loan origination costs. Furthermore, immediately after upholding the deductibility of advertising costs after *INDOPCO* as a specifically allowed exception to capitalization, the Service handed down Technical Advisory Memorandum (TAM) 92-40-004.¹⁰⁴ The TAM discussed the tax ramifications of costs incurred to remove asbestos insulation from manufacturing equipment. The Service concluded that because the taxpayer received long term future benefits that ex-

102. *Id.*; see, e.g., *Cleveland Elec. Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1975) (capitalization of advertising costs incurred to allay public opposition to the granting of a license to a nuclear power plant).

103. Emerson J. Addison, Jr., *INDOPCO I: IRS Rules Advertising Deductible . . .*, 23 TAX ADVISER 801, 802 (1992).

104. Tech. Adv. Mem. 92-40-004 (June 29, 1992). The Service stated that the costs of replacing asbestos were capital expenditures because the taxpayer received long-term future benefits that were expected to accrue beyond the year in question. *Id.*; see Dean A. Rocheleau, . . . *INDOPCO II: IRS Disallows Deductions for Asbestos Removal*, 23 TAX ADVISER 802, 804 (1992) ("According to Letter Ruling (TAM) 9240004 . . . the Service's rationale in deciding when taxpayers are entitled to deduct repairs as current business expenses is changing, in large part based on its recent victory in the Supreme Court's decision in *INDOPCO*") (citation omitted).

tended beyond the year in question, the costs were required to be capitalized.

Thus, although the ABA would hope that Revenue Ruling 92-80 would be extended to allow deduction of loan origination costs after *INDOPCO*, Revenue Ruling 92-80 clearly appears only to allow the deductibility of a cost Congress has specifically allowed to be deducted. If no specific allowance for deduction appears in the Code or Regulations, as was the case with asbestos removal in TAM 92-40-004, it appears that capitalization is required. Accordingly, the Agents would probably argue that loan origination costs, as non-excepted expenses, must be capitalized.

H. *Statement of Financial Accounting Standards No. 91*

The Agents also rely on the Statement of Financial Accounting Standards (SFAS) No. 91.¹⁰⁵ This 1986 Statement changed the generally accepted accounting principles (GAAP) for loan origination expenses. Under SFAS No. 91, banks and other lenders are required to capitalize and amortize loan origination costs over the life of the loan.¹⁰⁶ The expected significance of SFAS No. 91 for the Agents is that the new accounting requirements mean that loan origination costs can now quite readily be measured because they now must be accounted for separately.¹⁰⁷

SFAS No. 91 was enacted because a few financial institutions were attempting to improve the appearance of their financial statements by booking unusually large loan origination costs in the year of loan origination, even if the costs clearly were offset by interest received over the life of the loan.¹⁰⁸ Thus the banks might conclude that neither the purpose nor the intent of the statement was to separately keep track of the costs of origination in order to tax them differently. Rather, the rule was promulgated to stop the abuse of receiving a double benefit. Based on the purpose of SFAS No. 91, the banks can argue that SFAS No. 91 should not operate to influence the tax consequences of loan origination costs.

105. SFAS 91, *supra* note 23. See Thomas P. Ochenschlager, *Capitalization of Loan Origination Costs?*, TAX ADVISER, Feb. 1993, at 94.

106. SFAS 91, *supra* note 23, ¶ 5. "Direct loan origination costs . . . include only (a) incremental direct costs of loan origination . . . incurred in transactions with independent third parties . . . and (b) certain costs directly related to specific activities performed by the lender." *Id.* ¶ 6. The board stated that examples of loan origination costs include: evaluating the borrower's finances and credit risk, evaluating and recording guarantees, collateral and other security arrangements, negotiating loan terms, preparing and processing loan documents and closing the transaction. *Id.*

107. Goeller, *supra* note 75, at 3; Ruempler & Salfi, *supra* note 1, at 1749.

108. Ruempler & Salfi, *supra* note 1, at 1749. See SFAS 91, *supra* note 23, ¶ 44.

The Agents, by using SFAS No. 91 and its deferral of costs, might have found a basis in accounting for their argument to capitalize loan origination costs. When the Accounting Board changes a method of accounting, the Agents could react by changing their position for the pragmatic purpose of preventing conflict with the FASB. Furthermore, that the Accounting Board may not have intended to effect a tax change does not mean that the Agents cannot use the change as a strong reason to change the taxing of loan origination costs.¹⁰⁹

IV. CONCLUSION

The Internal Revenue Service has recently given some direction to taxpayers who are unsure whether they should be deducting or capitalizing the costs incurred to make a loan.¹¹⁰ However, this announcement does not answer the question whether the loan origination costs are to be deducted or capitalized. Instead, it stops lenders from changing their accounting method of capitalizing loan origination costs until a ruling is given by the Service. Since a taxation guideline on loan origination costs has not yet been issued, an analysis of the arguments set forth by the Agents and the American Banking Association is helpful to determine what type of tax treatment will be given to loan origination costs.

The analysis should surround the case law precedent that should be cited by each side to the debate. The Agents can point to *INDOPCO*, *Idaho Power*, and *Lincoln Savings* to show the trend of the Supreme Court from the early 1970s through 1992. The leading case for the lending institutions is *Colorado Springs*, a

109. See Ruempler & Salfi, *supra* note 1, at 1749.

110. Announcement 93-60, 1993-16 I.R.B. 9 (April 19, 1993). This announcement stated that:

Lenders that desire to change their method of accounting from a method of deducting loan origination costs when paid to a method of capitalizing loan origination costs should not request permission to make this change from the National Office of the Internal Revenue Service at this time. This is a temporary suspension of the Service's ruling program with respect to this matter, pending the issuance of a revenue procedure for lenders who wish to change their method of accounting for loan origination costs.

Id. The announcement further provided that any Form 3115, Application for Change in Accounting Method, currently on file will be returned to the taxpayer except where the issue of loan origination costs is currently pending. A taxpayer who is being audited or who gets audited before an Internal Revenue Service decision is handed down may file a Form 3115 application with the Field Agent during the examination. The announcement concluded by informing taxpayers that they will not be adversely affected by being forced to file a method change request with an auditor as compared with other taxpayers. *Id.*; see also *Rulings on Change of Method for Deducting Loan Origination Costs Temporarily Suspended*, 79 J. TAX'N 174 (1993).

Tenth Circuit decision from the early 1970s.

INDOPCO, the most recent decision handed down by the Supreme Court on the issue of deductibility versus capitalization, can be viewed as clarifying the previous three decisions. Blackmun's majority opinion indirectly affirmed and expanded the propositions advanced in *Idaho Power* and *Lincoln Savings*, i.e., the useful life of the asset test, and the separate and distinct asset test, respectively. The *INDOPCO* Court, in furtherance of *Lincoln Savings*, characterized a deduction as a matter of legislative grace, one of a set of specifically enumerated exceptions to the norm of capitalization. Additionally, the Court followed *Idaho Power* by providing that one needs to match expenses with revenues and to look at the extent and duration of the benefits received in determining the useful life of an expense.

The *INDOPCO* decision not only allows the application of *Lincoln Savings*, it has broadened it to a much more expansive set of circumstances. In doing so, the Court is effectively limiting the use of *Colorado Springs* as future precedent. While reviewing the separate and distinct asset test of *Lincoln Savings*, the *INDOPCO* Court stated:

It by no means follows . . . that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263. . . . In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure.¹¹¹

Therefore, the main argument presented by the ABA under *Colorado Springs*, i.e., that a loan origination cost is not a separate and distinct asset and thus must be deducted, appears to have disintegrated in light of the clarification of the *Lincoln Savings* test in *INDOPCO*.

The Supreme Court in *INDOPCO* analyzed the deductibility of an expense based on sections 162 and 263 of the Code, the sections that have always been applied in previous decisions. The ABA might attempt to bring in sections 195 and 263A, but neither helps clear up the dilemma. Expansion costs of an existing business were found not to be deductible in *INDOPCO*; thus, they can not be amortizable under section 195. In Notice 88-86, although the Service stated that loan origination costs do not have to be capitalized under section 263A, they specifically stated that they were referring to only section 263A. Thus, the use of any other Code section to clarify the issue at hand appears useless.

111. *INDOPCO*, 112 S. Ct. at 1044.

Finally, in *INDOPCO*, the Court referred to the exclusive list of deductible expenses, and this concept is clearly followed in Revenue Ruling 92-80 and TAM 92-40-004. Advertising, a specific Congressional exception, remained deductible, while asbestos removal costs, a non-enumerated deduction, had to be capitalized.

Therefore, based on all of the information that can be presented by both sides of the issue, the reasoning of the IRS Field Agents appears much stronger than that of the ABA lending institutions. Accordingly, the future trend in taxation will inevitably follow the lead of *INDOPCO*. Thus, because loan origination costs are not a specifically enumerated deduction, and are incurred to create an asset from which benefits flow to the lender beyond the current taxable year, they will be required to be capitalized and not deducted.