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Rev. Rul. 94-77

Issue

Does the Supreme Court's decision in *INDOPCO, Inc. v. Commissioner*, ___ U.S. ___, 112 S.Ct. 1039 [69 AFTR 2d 92-694] (1992), affect the treatment of severance payments, made by a taxpayer to its employees, as business expenses which are generally deductible under section 162 of the Internal Revenue Code?

Law and Analysis

Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-7(a) of the Income Tax Regulations provides that a reasonable allowance for salaries or other compensation for personal services actually rendered is among the items included in deductible business expenses under section 162. In addition, section 1.162-10 provides a deduction for ordinary and necessary business expenses paid or incurred for dismissal wages, unemployment benefits, and guaranteed annual wages.

Section 263(a) and section 1.263(a)-1(a) provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property.

Through provisions such as sections 162(a), 263(a), and related sections, the Internal Revenue Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e.g., *INDOPCO, Inc. v. Commissioner*, ___ U.S. ___, 112 S.Ct. 1039, 1043 (1992); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 [34 AFTR 2d 74-5244] (1974). In *INDOPCO*, the Supreme Court concluded that certain legal and professional fees incurred by a target corporation to facilitate a friendly merger created significant long-term benefits for the taxpayer, and, therefore, were capital expenditures. In reaching this decision, the Court specifically rejected the argument that its decision in *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971), should be read as holding "that only expenditures that create or enhance separate and distinct assets are to be capitalized under section 263." *INDOPCO* at 1044. (Emphasis in original).

The *INDOPCO* decision clarifies that the creation or enhancement of a separate and distinct asset is not a prerequisite to capitalization. That clarification does not, however, change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized. With respect to expenditures that produce benefits both in the current year and in future years, the determination of whether such expenditures must be capitalized requires a careful examination of all the facts. *INDOPCO* at 1044; Rev. Rul. 94-12, 1994-1 C.B. 36. Although the mere presence of some future benefit may not warrant capitalization, a taxpayer's realization of future benefits is undeniably important in determining whether an expenditure is immediately deductible or must be capitalized. *INDOPCO* at 1044-45.

Thus, for example, the cost of incidental repairs and advertising is generally deductible even though advertising and incidental repairs may have some future benefit. Rev. Rul. 94-12; Rev. Rul. 92-80, 1992-2 C.B. 57. Similarly, although severance payments made by a taxpayer to its employees in connection with a business down-sizing may produce some future benefits, such as reducing operating costs and increasing operating efficiencies, these payments principally relate to previously rendered services of those employees. Therefore, such severance payments are generally deductible as business expenses under section 162 and section 1.162-10.

Holding

The INDOPCO decision does not affect the treatment of severance payments, made by a taxpayer to its employees, as business expenses which are generally deductible under section 162 and section 1.162-10.

However, pursuant to section 1.162-10T and section 404(b), if severance payments that would otherwise be deductible under section 162 are made to employees under a plan, method, or arrangement deferring the receipt of compensation, these payments are deductible under section 404(a) subject to the limitations thereof.

Further, this revenue ruling does not address, and no inference is intended regarding, the federal income tax treatment of severance payments made as part of the acquisition of property (including a deemed acquisition of assets pursuant to section 338).

Drafting Information

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