E-Commerce:
A Review and Analysis of Federal Domestic Tax Issues

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Overview

E-commerce is a new business model with transactions that don't always neatly fit within rules developed for older models. While there are many tax issues raised, from application of sales and telecommunications taxes to whether a computer server can be a permanent establishment, this outline and presentation focus only on issues under the federal domestic tax rules. This includes such issues 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 transfers of intangible assets to a corporation.

In October 1999, the SEC issued a letter to FASB describing 20 accounting issues related to Internet transactions for which the SEC desired guidance. Some of these issues also raise issues under the federal tax law and are discussed in this outline as well. The complete text of the October 1999 SEC letter is included in the appendix to this outline.

Tax Treatment of Web Site Development Costs

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 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.

<u>Web Site Development Activities and Relevant Tax Rules</u>

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 should be applied.[1] If the future benefit is speculative, capitalization is not warranted.[2] Also, if the primary benefit is to current year activities, the costs should be deductible under §162.[3]

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[1] *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

Acquisition of a Domain Name: Typically, a business obtains a domain name by registering with a registrar[4] 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.[5]

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 69-21,[6] 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 Revenue Procedure 69-21, a taxpayer who buys software would be able to amortize the cost ratably over five years, or less, if the taxpayer can prove the software has a shorter life. However, this life has been reduced to 36 months under §167(f) added by the Revenue Reconciliation Act of 1993.[7]

It is important to note that Revenue Procedure 69-21 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 resemble the kind of research and experimental expenditures that fall within the purview of §174 ... as to warrant accounting treatment similar to that accorded such costs under that section."

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 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.[8]

Revenue Procedure 69-21 does 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

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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."

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

3 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.

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

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

6 Rev. Proc. 69-21, 1969-2 C.B. 303.

7 RRA 1993, §13261(b)(1).

8 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."

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. *Queries*: 1) Does the Service agree with this definition of software development? 2) Does use of a software program to produce an HTML document constitute the production of code and therefore, software development? 3) 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.[9] 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.[10] 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.[11]

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.[12] 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.[13] 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).[14]

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."[15] Depreciable property is not a §174 expenditure, but the depreciation on equipment used in R&E falls under §174.[16] A product includes "any pilot model, process, formula, invention, technique, patent, or similar property and includes products to be used by the taxpayer it its trade or business as well as products to be held for sale, lease, or license.[17]

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

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9 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).

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

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

12 Treas. Reg. §1.174-2(a).

13 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.

14 Treas. Reg. § 1.174-2(a)(4).

15 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.

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

17 Treas. Reg. §1.174-2(a)(2).

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).[18]

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 expenditures 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."[19]

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. 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 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.[20]

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.[21] 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)."[22]

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[18] §41(d)(1)(A) and *Norwest Corp., et al. v. Comm'r.*, 110 T.C. No. 34 (1998).

[19] See Treas. Reg. §1.174-2(b)(3) and TAM 9449003 (Aug. 25, 1994).

[20] The question of whether use of a software program to create an HTML document constitutes software development is one in need of guidance. 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. Taxpayers should be allowed a choice of two different accounting methods for such costs: 1) a pool-of-costs capitalization and 36-month capitalization 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*, Summer 2000.

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

[22] Rev. Rul. 96-62, 1996-53 I.R.B. 6.

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.[23] In 1992, the U.S. Supreme Court attempted to clarify the demarcation between ordinary and capital expenditures in the *Indopco* decision.[24]

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."

If any costs incurred in developing a web site do not fall under §174 or Rev. Proc. 69-21 and provide a more than incidental future benefit, they should be capitalized.

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.”[25] 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.[26] 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,[27] "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.*,[28] 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

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

24 *Indopco*, 503 U.S. 79, 92-1 USTC ¶50,113, 69 AFTR2d 694 (1992).

25 *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 F2d 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 an 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.

26 IRC §195(c)(1)(B).

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

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

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,[29] 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.

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 that advertising expenditures are 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.[30] 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."

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

[30] 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.”

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. 69-21).

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. 69-21 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. 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 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.[31] The employee training costs were held to be capitalizable, in part,

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

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.[32]

In contrast, in Rev. Rul. 2000-4,[33] 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* cases[34] 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.

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).

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?

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[32] 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.

[33] Rev. Rul. 2000-4, 2000-4 I.R.B. 331.

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

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, 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 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:

Preliminary Project	Application Development	Post-Implementation/ Operation
(expense)	(capitalize)	(expense)
Conceptual formulation of alternatives	Design of chosen path, including software configuration and software interfaces	Training
Evaluation of alternatives	Coding	Application maintenance
Determination of existence of needed technology	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 video tape to communicate advertising is not a tangible asset.

Transfer of a Domain Name

Typically, a business obtains a domain name by registering with a registrar[35] 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.[36] 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.[37] 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."[38] 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.

In *Panavision Int'l v. Toeppen*,[39] 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*,[40] 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

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

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

37 The Associated Press, "Loans.com Domain Name Sells for $3 Million," *New York Times*, Technology Section, January 31, 2000.

38 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/.

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

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

business in New York. The court also noted that the long-arm statute of California was not as restrictive as that of New York.[41]

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. 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,[42] 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.

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,[43] 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.[44] 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.

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41 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?

42 The Anticybersquatting Consumer Protection Act (P.L. 106113, 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.

43 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).

44 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.

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.

Exchanges of Web Banner Ads

In IR-2000-03 and Notice 2000-6, 2000-3 I.R.B. 315, the IRS announced that it was eliminating the reporting requirement 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 and before new regulations are issued; thus, no reporting (1099-B) would be necessary for small 1999 transactions. 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 IRS 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 type of electronic service that the IRS *seems* to be addressing with the new reporting exception is banner ad exchanges of an inconsequential amount. 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

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?

Observation: 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).

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 §351[45] 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.[46] 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.[47] 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.[48]

Where a transfer involves all substantial rights in the property, it will likely be viewed as a transfer of property under §351.[49] The IRS has ruled that to constitute a sale or exchange, all substantial rights to the patent must be granted to the corporation.[50] However, in *E.I. Du Pont de Nemours* case,[51] 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

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45 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).

46 Treas. Reg. §1.351-1(a)(2).

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

48 Rev. Rul. 79-288, 1979-2 C.B. 139.

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

50 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.

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

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.[52] Similarly, in another case, the court stated that the term property "encompasses whatever may be transferred."[53]

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.[54] 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.[55] Generally, if the item transferred encompasses a "sufficient bundle of rights" it is likely to be viewed as constituting property.[56]

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.[57]

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.[58]

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.[59]

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.[60]

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[52] 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 (6/2477) and 38,114 (9/27/79).

[53] *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).

[54] *Stafford*, *supra*.

[55] *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.

[56] *Stafford*, *supra*, at 1052.

[57] See Rev. Rul. 64-56, *supra*, and cases cited therein.

[58] See *Stafford*, *supra*, at 1050.

[59] 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.

[60] 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.

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 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.[61]

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."[62]

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.

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

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

Issues for Tax-Exempt Organizations on the Internet

A tax-exempt organization that allows donors to be listed on the organization's web site, may 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 exchange, meets the tax definition of a tax-exempt organization.

These issues are beyond the scope of this outline. For information on the above issues and others related to tax-exempts and the Internet, see:

- Jody Blazek, "The Internet and Tax-Exempt Organizations," *The Tax Adviser*, May 2000, page 344.
- David Hardesty, "Tax-Exempts on the Internet – Receipts from Sponsors," www.ecommercetax.com/doc/051400.htm, May 14, 2000.

Appendix A
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 then 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 the 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 of 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).