

Section 162.—Trade or Business Expenses

26 CFR 1.162-1: Business expenses.
(Also §§ 263, 263A; §§ 1.263(a)-1, 1.263(a)-2, 1.263A-1)

Business expenses; capital expenditures; ISO 9000 costs. Costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification are deductible as ordinary and necessary business expenses under section 162 of the Code, except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (e.g., a quality manual). Rev. Proc. 99-49 modified and amplified.

Rev. Rul. 2000-4

ISSUE

Are costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification deductible as ordinary and necessary business expenses under § 162 of the Internal Revenue Code, or must they be capitalized under §§ 263 or 263A?

FACTS

ISO 9000 is a series of international standards for quality management systems that was developed by the International Organization for Standardization (ISO). The ISO 9000 series of standards is comprised of several specific requirements that are intended to ensure a quality process in providing services or products to an organization's customers.

To obtain ISO 9000 certification, an organization may incur internal and external costs to assess its current quality processes, create a quality manual, train its employees, and implement the new quality system. In addition, the organization incurs costs to obtain formal certification from an independent auditor (or "registrar") that its quality management system conforms to a specific ISO 9000 standard. This certification generally lasts from two to four years. After the initial certification, the organization incurs additional costs for periodic audits to maintain its certification and to renew the certification upon expiration of the initial certification pe-

riod. All these expenditures are referred to herein as "ISO 9000 costs."

Although ISO 9000 certification is voluntary, it increasingly is a contractual requirement for doing business with many organizations, both public and private, worldwide. ISO 9000 certification also is an alternative to product certification in some foreign markets, particularly the European Union.

LAW AND ANALYSIS

Section 162 and § 1.162-1(a) of the Income Tax Regulations generally allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Courts generally have construed § 162 as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) ordinary, (3) necessary, (4) paid or incurred during the taxable year, and (5) made to carry on a trade or business. See *Commissioner v. Lincoln Sav. and Loan Ass'n*, 403 U.S. 345 (1971).

Section 263(a) and § 1.263(a)-1(a) provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Section 263A provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer or real or personal property described in § 1221(1) that is acquired by the taxpayer for resale must be capitalized. Section 1.263A-1(e)(4)(iv)(F) cites quality control policy as an example of an indirect cost that generally is not allocated to production or resale activities.

Through provisions such as §§ 162(a), 263(a), and 263A, the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e.g., *INDOPCO, Inc. v. Commissioner*, 503 U.S.

79, 84 (1992); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974). Moreover, as the Supreme Court has specifically recognized, the "decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind," and a careful examination of the particular facts of each case is required. *Deputy v. du Pont*, 308 U.S. 488, 496 (1940); *Welch v. Helvering*, 290 U.S. 111, 114 (1933).

In determining whether a current deduction or capitalization is the appropriate tax treatment for an expenditure, it is important to consider the extent to which the expenditure will produce future benefits. See *INDOPCO*, 503 U.S. at 87-88. ISO 9000 certification potentially results in a number of benefits for a taxpayer. For example, certification may improve the overall quality of the taxpayer's business operations, give the taxpayer a marketing advantage by differentiating it from non-certified competitors, enable the taxpayer to retain customers that begin requiring their suppliers to be certified, and enable the taxpayer to expand its existing business to new markets and new customers that require their suppliers to be certified. These benefits generally both relate to the current taxable year and extend beyond the taxable year in which the taxpayer obtains ISO 9000 certification. Section 263(a), however, requires an examination of not only the duration of the benefits, but also the extent of the benefits. See *INDOPCO*, 503 U.S. at 87 (the mere presence of an incidental future benefit may not warrant capitalization). See also Rev. Rul. 96-62, 1996-2 C.B. 9 (training costs generally are deductible under § 162 even though they may have some future benefit); Rev. Rul. 94-12, 1994-1 C.B. 36 (incidental repair costs generally are deductible under § 162 even though they may have some future benefit); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising costs generally are deductible under § 162 even though they may have some future effect on business activities).

ISO 9000 certification does not result in future benefits that are more than incidental. The benefits derived from ISO 9000 certification are akin to the current benefits derived from advertising, training, and similar expenditures incurred in operating the taxpayer's business, retaining existing customers, or simply improving the overall quality or attractiveness of the taxpayer's

business operations. Although the enhanced marketability of the taxpayer's services or products resulting from ISO 9000 certification may yield future benefits such as repeat business or increased market share, these future benefits are incidental to the primary benefit of current sales. Expenditures that primarily benefit current operations generally are deductible. See, e.g., *Van Iderstine Co. v. Commissioner*, 261 F.2d 211 (2nd Cir. 1958) (payments made to suppliers to ensure a continuing supply of raw materials were deductible); *Snow v. Commissioner*, 31 T.C. 585 (1958), acq., 1959-2 C.B. 7 (payments made to protect and supplement the taxpayer's income from its existing law business were deductible). See also *T.J. Enterprises, Inc. v. Commissioner*, 101 T.C. 581 (1993) (expenses incurred to protect, maintain, or preserve a taxpayer's business generally are deductible).

Further, even if ISO 9000 certification facilitates the expansion of the taxpayer's existing business, the mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits. Compare *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2nd Cir. 1973) (expenditures incurred by the taxpayer to develop a new market for wholesale customers, which gave the taxpayer little more than an expectation or hope of future sales, were deductible under § 162); *Sun Microsystems v. Commissioner*, T.C. Memo 1993-467 (costs incurred to promote sales of computer workstations were not capital expenditures because the anticipated long-term benefits from the customer relationship were "softer" and more speculative than the immediate benefits from the sales) with *FMR Corp. v. Commissioner*, 110 T.C. 402 (1998) (costs to develop and launch mutual funds, which resulted in new long-term management contracts, were capital expenditures).

Because ISO 9000 certification yields only incidental future benefits, ISO 9000 costs are distinguishable from costs incurred to obtain licenses, stock trading privileges, state bar certifications, and similar market-entry requirements that have been held to be capital expenditures. Unlike ISO 9000 certification, these requirements are an essential element to the establishment of the taxpayer's business and result either in a separate and distinct asset or in significant future benefits. See, e.g., *Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951)

(payment to obtain liquor license was a capital expenditure); *Harman v. Commissioner*, 72 T.C. 362 (1979) (initiation fees required to obtain a seat on the New York Stock Exchange were capital expenditures); *Sharon v. Commissioner*, 66 T.C. 515 (1976), *aff'd*, 591 F.2d 1273 (9th Cir. 1978) (costs incurred by an attorney for admission to various bars were capital expenditures).

Accordingly, ISO 9000 certification does not itself result in the creation of an asset having a useful life substantially beyond the taxable year. To the extent the ISO 9000 certification process results in the creation of an asset, however, § 263(a) requires capitalizing the costs allocable to creating that asset. For example, the costs of creating a quality manual must be capitalized, even though costs of periodic updates to the manual may be deducted. § 263A; § 1.263A-2(a)(2)(ii), *Domestic Management Bureau v. Commissioner*, 38 B.T.A. 640 (1938) (costs of preparing and printing a training manual were capital expenditures); Rev. Rul. 96-62 (costs of routine updates of training materials are deductible). In addition, if the certification process requires the acquisition of an asset, such as machinery and equipment, the costs of that asset must be capitalized under § 263(a).

Further, ISO 9000 costs, other than costs incurred during the certification process that are allocable to creating an asset such as a quality manual, are not costs that are allocable to production or resale activities for purposes of the uniform capitalization rules of § 263A, and thus are not subject to the rules set forth in that section or the regulations thereunder. See § 1.263A-1(e)(4)(iv)(F) (quality control expenditures generally excepted from uniform capitalization rules).

HOLDING

Costs incurred by a taxpayer to obtain, maintain, and renew ISO 9000 certification are deductible as ordinary and necessary business expenses under § 162, except to the extent they result in the creation or acquisition of an asset having a useful life substantially beyond the taxable year (e.g., a quality manual).

APPLICATION

Any change in a taxpayer's method of accounting to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply.

A taxpayer wanting to change its method of accounting to conform with the holding in this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, 1999-52 I.R.B. 725, except that the scope limitations in section 4.02 of Rev. Proc. 99-49 do not apply. However, if the taxpayer is under examination, before an appeals office, or before a federal court with respect to any income tax issue, the taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the Form 3115 with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99-49 is modified and amplified to include the prospective change in accounting method in the APPENDIX.

DRAFTING INFORMATION

The principal author of this revenue ruling is Kimberly L. Koch of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Koch at (202) 622-4950 (not a toll-free call).