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1999-012  
October 4, 1999  
Attachment 1

### **ACTION ON DECISION**

**Subject:** RJR Nabisco, Inc., et al., v. Commissioner,  
T.C. Memo. 1998-252 (Dkt. No. 3796-95)

**Issue:** Whether graphic design and advertising campaign costs incurred by petitioner are currently deductible business expenses under I.R.C. § 162 or are properly treated as capital expenditures under I.R.C. § 263.

**Discussion:** Petitioner claimed current deductions on its consolidated tax return for the cost of developing graphic designs and advertising campaigns for its cigarette products. The Commissioner disallowed the deductions on the grounds that petitioner had failed to show that the costs were deductible under § 162 and that said costs constituted capital expenditures under § 263. The graphic design costs included the cost of developing graphic designs for cartons, packages, flags (messages temporarily applied to cartons or packages), tipping (the printed wrapper around the filter), cigarette papers (which hold the tobacco), foils (the inner lining between the cigarettes and soft-pack or box), and for soft-packs, a closure seal. The advertising campaign costs included the cost of developing an advertising campaign, but did not include the cost of executing those campaigns.

For purposes of the case, the parties agreed to litigate the deductibility of only a portion of the disallowed deductions (the "litigated expenses") and agreed to settle their disagreement over the remaining disallowed deductions on the basis of the courts decision with respect to the litigated expenses. Neither party asked the court to address separately the small portion (approximately 1.5 percent) of the litigated expenses that related to the design of the physical construction of cigarette packages (as opposed to the graphics) and the Service did not allege that such costs should be treated differently.

The Tax Court held that the graphic design and advertising campaign costs incurred by petitioner are currently deductible business expenses under I.R.C. §162. The Tax Court characterized the graphic design and advertising campaign costs as advertising costs and held the costs were deductible on the ground that the Service had conceded the deductibility of advertising costs in Rev. Rul. 92-80, 1992-2 C.B. 57.

Rev. Rul. 92-80 holds that the Supreme Court's decision in INDOPCO v. Commissioner, 503 U.S. 79 (1992), does not affect the deductibility of advertising costs. The revenue ruling does not hold that all advertising costs are deductible. The revenue ruling states that advertising costs are generally deductible even though advertising may have some future benefit. The revenue ruling further states that advertising costs must be capitalized in the unusual circumstance where it is directed

towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising.

We disagree with the rationale of the Tax Court. Rev. Rul. 92-80 should not be read as a concession that package design costs are advertising and, therefore, deductible. In Rev. Rul. 89-23, 1989-1 C.B. 85, modified in Rev. Proc. 98-39, 1998-26 I.R.B. 36, the Service concluded that package design costs are capital expenditures and that package designs have an indeterminate useful life. Rev. Rul. 89-23 states that advertising costs are distinguishable from package design costs (as defined in the ruling) and are deductible either because they are of a recurring nature or because their benefit does not extend beyond the tax year. See Davee v. United States, 444 F.2d 551 (Ct. Cl. 1971). The ruling also states, however, that package design costs are capital expenditures because they more closely resemble nonrecurring promotional or advertising costs that result in benefits which extend beyond the year in which the costs are incurred. See Alabama Coca-Cola Bottling Co. v. Commissioner, T.C. Memo. 1969-123; Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985).

The Tax Court characterized graphic design and advertising campaign costs as advertising costs and, based on that characterization, concluded that the costs were deductible under Rev. Rul. 92-80. We believe the Tax Court erred by finding that the Service had conceded the deductibility of advertising costs in Rev. Rul. 92-80 and in not considering Rev. Rul. 89-23. The Service has expressly determined that package design costs are essentially different from deductible advertising costs. We disagree with the opinion and do not acquiesce. We will continue to litigate the treatment of package design costs where appropriate.

**Recommendation: Nonacquiescence**

**Reviewers:**

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