Kansas City Southern Industries, Inc. v. Commissioner, 98 T. C. 242 (1992)

A taxpayer's request to revoke an election to amortize railroad grading under Section 185 may be granted if the IRS's denial of such request constitutes an abuse of discretion.

Summary

Kansas City Southern Industries, Inc. (KCSI) sought to revoke its election to amortize railroad grading costs under Section 185, aiming to claim investment tax credits instead. The IRS denied this request, arguing that grading was not eligible for such credits. The Tax Court found that the IRS's denial was an abuse of discretion, as it aimed to prevent KCSI from benefiting from favorable judicial precedent. Additionally, the court ruled that sidetrack deposits did not constitute taxable income upon construction completion, and that purchased computer software was intangible property not eligible for investment tax credits.

Facts

KCSI, a holding company, elected in 1970 to amortize railroad grading under Section 185 for the years 1970-1976. In 1977, after a favorable Tax Court decision on similar issues for prior years, KCSI applied to revoke this election for 1977 and subsequent years to claim investment tax credits. The IRS denied the application, asserting that grading was not eligible for such credits. KCSI's subsidiaries also received deposits for sidetrack construction, and KCSI purchased computer software for business use.

Procedural History

KCSI filed its election to amortize grading in 1971 for the 1970 tax year. In 1977, after a favorable decision in related cases for earlier years, KCSI applied to revoke this election. The IRS initially suspended action on this request, then formally denied it in 1983. KCSI challenged this denial in the Tax Court, which found the IRS's action to be an abuse of discretion.

Issue(s)

1. Whether the IRS's denial of KCSI's application to revoke its Section 185 election was an abuse of discretion?
2. Whether deposits received by KCSI's subsidiaries for sidetrack construction constituted income upon completion of construction?
3. Whether computer software purchased by KCSI was tangible personal property eligible for investment tax credit?

Holding

1. Yes, because the IRS's denial was an abuse of discretion aimed at preventing

KCSI from relying on favorable judicial precedent.
2. No, because the deposits were subject to an obligation to repay, lacking the guarantee necessary for them to be considered income upon construction completion.
3. No, because the intrinsic value of the software was attributable to its intangible elements, not its tangible media.

Court's Reasoning

The court held that the IRS abused its discretion by denying KCSI's revocation request, as this action was motivated by a desire to enforce an administrative position contrary to judicial decisions. The court emphasized that the purpose of Section 185 was to provide an alternative cost recovery method, and that KCSI should be allowed to revoke its election to take advantage of evolving case law favoring depreciation and investment tax credits. Regarding sidetrack deposits, the court applied the principle from *Commissioner v. Indianapolis Power & Light Co.* that deposits subject to an obligation to repay are not income upon receipt. For the computer software issue, the court followed its precedent in *Ronnen v. Commissioner*, applying the "intrinsic value" test to conclude that the software's value was in its intangible elements, thus not eligible for investment tax credits.

Practical Implications

This decision clarifies that taxpayers may revoke Section 185 elections if the IRS's denial is found to be an abuse of discretion, particularly when motivated by a desire to negate judicial precedent. Practitioners should closely review IRS denials of such requests for signs of arbitrary action. The ruling on sidetrack deposits reaffirms that deposits subject to repayment are not taxable upon receipt, impacting how similar agreements should be structured and reported. Finally, the court's stance on computer software's intangibility guides the treatment of software purchases for tax purposes, affecting how businesses account for such assets in claiming tax credits.

