The Law School

University of Southern California

2004 TAX INSTITUTE

January 26, 2004

CAPITALIZE THIS!

THE LATEST IN INTANGIBLES AND *INDOPCO*

Edwin G. Schuck, Jr.
McDermott, Will & Emery
2049 Century Park East, Suite 3400
Los Angeles, California 90067-3208
(310) 551-9307
eschuck@mwe.com

CAPITALIZE THIS! THE LATEST IN INTANGIBLES AND *INDOPCO*

Edwin G. Schuck, Jr.*

I. Introduction. This article reviews the current state of the tax law regarding the capitalization of intangibles in light of post-*INDOPCO* litigation and the issuance, at the very end of 2003, of final regulations governing that topic.

A. The Basics – Capitalization Generally. There are two types of expenditures for tax purposes: those that may be deducted currently under Section 162(a)[1] and those that may not be deducted currently but must be capitalized under Section 263(a). Section 162(a) allows the deduction of "all the ordinary and necessary expenses paid or incurred during the year in carrying on any trade or business,"[2] while Section 263(a)(1) allows no deduction for a capital expenditure -- that is, for an "amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[3] A capitalized expenditure usually is amortized or depreciated over the life of the asset to which it is allocable, or, if no specific asset or useful life can be ascertained, is deductible only upon liquidation and dissolution of the enterprise.[4]

As one commentator has observed:

> Thus, the issue, in theory, is not whether the expense can be deducted, but, rather, when it will be deducted. Although the issue might appear to be one merely of timing, the difference between a current deduction and one that is amortized over fifteen years or

---

* Partner, McDermott, Will & Emery (Los Angeles)

1 All Section references are to the Internal Revenue Code of 1986, as amended ("I.R.C." or the "Code"). All references to "Reg. §" are to the Treasury Regulations.

2 I.R.C. § 162(a). Expenses that would otherwise be deductible under I.R.C. § 162 that are paid or incurred prior to the commencement of "carrying on any trade or business," *i.e.*, pre-opening, start-up, or investigatory costs, are not currently deductible but may, if an election is timely made, be capitalized and amortized as deferred expenses over a 60-month period under I.R.C. § 195. *See, e.g., Specialty Restaurants Corp. v. Commissioner*, T.C. Memo. 1992-221, 63 T.C.M. (CCH) 2759 (1992) (parent restaurant company established new restaurants with consolidated subsidiaries; parent's deductions for payment of subsidiaries' pre-opening expenses were disallowed as capital contributions; subsidiaries were denied the deduction because business operations had not commenced and the § 195 election had not been made).

3 I.R.C. § 263(a)(1).

4 *See* I.R.C. §§ 167(a), 336(a); Reg. §1.167(a).

> that is available only when the enterprise terminates (which may be decades in the future) is one of real dollars, witness the willingness of taxpayers and the government to litigate about the issue. A tax benefit realized today is worth significantly more than a benefit realized ten or twenty years from now.[5]

The cases tell us that the diverse operation of Sections 162(a) and 263(a) is for the purpose of matching expenses with the revenues of the taxable period to which they are properly attributable, thus seeking to more clearly reflect income.[6] The United States Supreme Court explains the contrasting roles of Sections 162 and 263 in terms of capitalization being the *general* rule for an expenditure and current deductibility being a specific exception provided by the legislature for identified circumstances only:

> In exploring the relationship between deductions and capital expenditures, this Court has noted the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." . . . The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See §§ 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures," … § 263 serves as a

5 Peter L. Faber, *Indopco: The Still Unsolved Riddle*, 47 Tax Law. 607 (1994).

6 *See*, *e.g.*, *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983) ("Thus, an expenditure that would ordinarily be a deductible expense must nonetheless be capitalized if it is incurred in connection with the acquisition of a capital asset. . . . The function of these rules is to achieve an accurate measure of net income for the year by matching outlays with the revenues attributable to them and recognizing both during the same taxable year. When an outlay is connected to the acquisition of an asset with an extended life, it would understate current net income to deduct the outlay immediately. To the purchaser, such outlays are part of the cost of acquisition of the asset, and the asset will contribute to revenues over an extended period. Consequently, the outlays are properly matched with revenues that are recognized later and, to obtain an accurate measure of net income, the taxpayer should deduct the outlays over the period when the revenues are produced."); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) ("Through provisions such as these [§§ 162(a) & 263(a)], the

general means of distinguishing capital expenditures from current expenses. . . .[7]

B. Capitalization of Intangibles – the Cases Before and After *INDOPCO*. The capitalization requirement, of course, extends to the costs of intangible, as well as tangible, assets.[8] The rather extensive jurisprudence of the United States Supreme Court on this subject shows us that the question what is "ordinary" in determining whether an admittedly "necessary" expense is capital in nature can be especially difficult in the context of an expense in respect of an intangible. In a famous and much-quoted 60-year-old Supreme Court case involving just such an expense in respect of an intangible, Justice Cardozo wrote:

> "Here, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute [Section 162(a)] is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.[9]

Halfway to the present, 30 years later, the Second Circuit was moved to observe:

> In the realm of intangibles, however, the rulings and decisions are in a state of hopeless confusion. . . .[10]

and then:

Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.").

7 *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (citations omitted). The Court's view that I.R.C. § 162 is subservient to Section 263 was not received uncritically. *See, e.g.,* Peter L. Faber, *Indopco: The Still Unsolved Riddle*, 47 Tax Law. 607 (1994); Irving Salem and John J. Clair, Jr., *Emerging Post-INDOPCO Issues: Rationale and Strategies*, 98 TNT 50-88 (March 16, 1998); Glenn Carrington, *Capitalization after INDOPCO and into the New Millennium*, 2001 TNT 214-59, (Nov. 5, 2001).

8 *See*, *e.g.*, Reg. § 1.263(a)-2; *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1973) (requiring capitalization of depreciation of machinery used to construct a capital asset).

9 *Welch v. Helvering*, 290 U.S. 111, 114-115 (1933) (payments by former corporate secretary to creditors of his former bankrupt employer, made to reestablish his relations with customers and to solidify

This kind can come forth by nothing, but by prayer and fasting.[11]

The state of the law, as it has developed in the cases, has not improved in the 30 more years since that opinion was rendered. Instead, the more recent cases have spawned a whole new school of controversies. The seminal cause of this condition is, of course, the 1992 *INDOPCO* case[12] in which the Supreme Court clarified a perceived uncertainty in its holding in the earlier *Lincoln Savings* case[13] while setting up yet a new uncertainty.

In the Supreme Court cases prior to *Lincoln Savings* involving the capitalization *vel non* of expenses in respect of intangibles, the Court considered legal, accounting and appraisal expenses incurred in purchasing a minority stock interest (capital),[14] consulting, legal and other professional fees incurred by acquiring company in minority stock appraisal proceeding (capital),[15] legal expenses incurred in defending against securities fraud charges (currently deductible),[16] legal expenses incurred in disputing an adverse postal designation (currently deductible),[17] payment by a parent company to cover its subsidiary's operating deficit (capital),[18] expenses incurred by a shareholder in helping executives of a company acquire its stock (capital),[19] brokerage commissions on the purchase of shares (capital),[20] and payments of another's debts to improve business reputation (capital).[21]

With the arguable exception of *Welch v. Helvering*, all of those pre-*Lincoln Savings* cases in which capitalization was held by the Court to be required involved an existing and identifiable intangible asset to which the expenditure in question was

---

his credit and standing in his new business, while concededly "necessary" held not to be "ordinary" and therefore to be capital in nature.

[10] *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973).

[11] *Id.*

[12] *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

[13] *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971).

[14] *Woodward v. Commissioner*, 397 U.S. 572 (1970).

[15] *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).

[16] *Commissioner v. Tellier*, 383 U.S. 687 (1966).

[17] *Commissioner v. Heininger*, 320 U.S. 467 (1943).

[18] *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943).

[19] *Deputy v. DuPont*, 308 U.S. 488 (1940).

[20] *Helvering v. Winmill*, 305 U.S. 79 (1938).

[21] *Welch v. Helvering*, 290 U.S. 111 (1933).

properly allocable. Even in *Welch v. Helvering*, the identifiable asset was, arguably, the reputation (goodwill) of the individual who paid his former employer's debts to enhance it.[22]

In *Lincoln Savings*, initially, there was no existing asset. The Court was presented with the question how to characterize the government-mandated payment of funds into a special FSLIC separate "secondary" reserve account by an insured savings and loan institution. The payment was an "additional premium" (in addition to the basic annual FSLIC insurance premium), and the resulting fund balance could be transferred to a successor, might ultimately be refunded, earned income and could in some circumstances be used as a credit against the insured institution's obligation to pay the basic "primary" insurance premium. The Court, in holding that the payment was not currently deductible, stated:

> . . . the possibility of a future benefit from the expenditure does not serve to make it capital in nature as distinguished from an expense.
>
> What is important and controlling, we feel, is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a). . . .[23]

Thus, in *Lincoln Savings* the Court appeared to establish a "separate and distinct individual asset" criterion for characterizing a payment as capital in nature and seemed to suggest that the possibility of a future benefit was not enough to make an expenditure nondeductible.

Litigation after *Lincoln Savings* focused on whether the separate and distinct additional asset criterion was the essential factor in the capital/deductible determination

---

[22] *Id.*, at 115-116 ("Reputation and learning are akin to capital assets, like the good will of an old partnership. . . . For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense in the operation of a business").

as it applies to intangibles. In the *Briarcliff Candy* case,[24] the Second Circuit suggested that *Lincoln Savings* "brought about a radical shift in emphasis," making capitalization dependent on whether the expenditure creates or enhances a separate and distinct additional asset, and in the *NCNB* case,[25] the Fourth Circuit held that bank expenditures for expansion-related planning reports, feasibility studies and regulatory applications did not "create or enhance separate and identifiable assets," and were therefore ordinary and necessary under Section 162(a).[26]

The issue came to a head in *INDOPCO*, where a separate and distinct additional asset had not been created. There, the Supreme Court was faced with an apparent conflict among the circuits because the Third Circuit in that case,[27] affirming the Tax Court, had held that payment by an acquired corporation for investment bankers and lawyers fees in connection with the transaction were capital expenditures because of the long-term benefits that would accrue to the taxpayer from the acquisition and rejected the taxpayer's argument that the expenses were deductible currently inasmuch as they did not "create or enhance . . . a separate and distinct additional asset" as required by *Lincoln Savings*. The *INDOPCO* Court affirmed the Third Circuit, clarifying that it does not follow from *Lincoln Savings* that only expenditures that create or enhance separate and distinct assets are to be capitalized under Section 263. The Court stated:

> We had no occasion in Lincoln Savings to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, Lincoln Savings holds that the creation of

---

23 *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 354 (1971).

24 *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 782 (2d Cir. 1973), *rev'g* T.C. Memo. 1972-43, 31 T.C.M. (CCH) 171 (1972) (expenses to advertise for and solicit new franchises for existing product in suburban locations held to be currently deductible as business expansion costs that did not create a separate and distinct additional asset).

25 *NCNB Corp. v. United States*, 684 F.2d 285, 293-294 (4th Cir. 1982), *vacating* 651 F.2d 942 (4th Cir. 1981), and *aff'g* 78-2 U.S.T.C. ¶ 9661 (W.D.N.C. 1978).

26 *See also Central Texas Savings & Loan Ass'n v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984) (inquiring whether establishment of new branches "creates a separate and distinct additional asset" so that capitalization is required).

> a separate and distinct asset may well be a sufficient, but not a necessary, condition to classification as a capital expenditure. . . .
>
> Nor does our statement in Lincoln Savings that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on a future benefit as a means of distinguishing an ordinary expense from 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.[28]

The *INDOPCO* Court agreed with the lower courts in that case that the acquisition "produced significant benefits to [the acquired corporation] that extended beyond the tax year in question and are amply supported by the record."[29] The Court then characterized the expenses at issue as not ordinary and necessary business expenses because, consistent with existing authority, they were "incurred for the purpose of changing the corporate structure for the benefit of future operations. . . ."[30]

While the Court in *INDOPCO* certainly clarified the point that the creation or enhancement of a separate and distinct additional asset is not the *sine qua non* for capitalization, it provided no further guidance as to the parameters of the "future benefit" that must obtain to deny current deductibility (other than to suggest that an "incidental" benefit would not warrant capitalization). It not only did not indicate what level or quantity of future benefit might be required, it did not state, definitively, whether a significant future benefit would require capitalization in all cases. Moreover, the Court

---

27 *National Starch & Chemical Corp. v. Commissioner*, 918 F.2d 426, 432-433 (3d Cir. 1990), *aff'g* 93 T.C. 67 (1989).

28 503 U.S. at 87.

29 503 U.S. at 88.

30 503 U.S. at 89 (citing *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir.), *cert. denied*, 379 U.S. 382 (1969), and *Farmers Union Corp. v. Commissioner*, 300 F.2d 197, 200 (9th Cir.), *cert. denied*, 371 U.S. 861 (1962)).

did not indicate to what extent the creation or enhancement of a "separate and distinct additional asset" might play a continuing role, especially where, although such an asset may be created or enhanced, it provides only an "incidental" future benefit.

Although the Court opened its analysis of the case with what can be described as a "clear reflection of income" discussion (specifically referring to matching of revenue and deductions to get a "more accurate calculation of net income),[31] it did not specifically base its opinion on that principle (or otherwise refer to Section 446). Accordingly, the case might be read, with its conclusory statements regarding the precedence of Section 263 over Section 162 and its only identified exception to "future benefit" being an "incidental benefit," to express the principle that any expenditure that produces a future benefit that is not incidental must be capitalized unless the taxpayer can satisfy the (apparently high) burden in such a case that it is both ordinary and necessary in carrying on the trade or business at hand. For example, had *INDOPCO* been premised on the "clear reflection" principle, there would be a very strong argument that expenditures that are "regular and recurring" in the trade or business (and that do not produce a separate and distinct additional asset) are ordinary and necessary even though they may produce a significant future benefit for the taxpayer.[32] Stated another way, by failing to specifically couch its holding in terms of seeking to clearly reflect income under Section 446, the Court, notwithstanding that its specific holding was unremarkable on the facts and consistent with well-established principles, left open an approach to capitalization, especially in respect of intangibles, that could be overbroad if zealously pursued.

Although it repeatedly denied that *INDOPCO* had changed "the fundamental principles governing capitalization,"[33] its victory in *INDOPCO* emboldened the government, during the following decade, to seek capitalization in a great many cases where the expenditure in question "produced significant benefits" to the taxpayer that extended beyond the year of payment but that had theretofore been thought, generally, to

---

[31] 503 U.S. at 84.

[32] For a thorough exposition of this view, *see* Peter L. Faber, *Indopco: The Still Unsolved Riddle*, 46 Tax Law. 607 (1994).

[33] Rev. Rul. 94-12, 1994-1 C.B. 36; Notice 96-7, 1996-6 I.R.B. 22.

be currently deductible.[34] For example, in the *Federated Department Stores* case,[35] the first major post-*INDOPCO* case, the government argued that break-up fees paid to a white knight in an unsuccessful hostile takeover defense must be capitalized under *INDOPCO* because the break-up fees were intended to change the corporate structure for the benefit of future operations. The district court, affirming the bankruptcy court, held the break-up fees to be deductible under Section 162 because the white knight's friendly acquisition had failed in each instance and the costs incurred to defend a business against attack are always ordinary and necessary, a long-established principle not undermined by *INDOPCO.* In so holding, the court found that in each instance that the break-up fees were not incurred to restructure the taxpayer in hopes of some future benefit but were entirely defensive in nature and that there were no long-term synergies or other benefits to the acquired corporation as there were in the friendly *INDOPCO* acquisition.[36]

The next major post-*INDOPCO* case was *A.E. Staley Mfg. Co.*[37] In that case, the taxpayer paid investment bankers fees to help ward off a hostile takeover; the defensive actions were ultimately unsuccessful and the taxpayer was acquired by the hostile bidder. The Seventh Circuit reversed the Tax Court and held that the bulk of the fees, which related to defensive measures and alternative transactions, did not facilitate the hostile acquisition and, were, therefore, currently deductible, under long-established authority, as expenses to defend or protect a business. A minor portion of the fees, relating to valuing the taxpayer's business, served to facilitate the acquisition and so were held to be capitalizable. The Court distinguished *INDOPCO* as involving a friendly acquisition in which all the investment banking fees "facilitated" the acquisition.

---

[34] *See, e.g.,* Lee A. Sheppard, *Is the IRS Abusing INDOPCO?,* 56 TAX NOTES 1110 (1992). The government's post-*INDOPCO* positions are exhaustively documented in Peter L. Faber, *Indopco: The Still Unsolved Riddle*, 46 Tax Law. 607 (1994); Irving Salem & John J. Clair, Jr., *Emerging Post-INDOPCO Issues: Rationale and Strategies*, 98 TNT 50-88 (March 16, 1998); Glenn Carrington, *Capitalization after INDOPCO and into the New Millennium*, 2001 TNT 214-59 (Nov. 5, 2001).

[35] *Federated Department Stores*, 94-2 U.S.T.C. ¶ 50,430 (S.D. Ohio 1994), *aff'g* 92-1 U.S.T.C. ¶ 50,097 (Bnkr., S.D. Ohio 1992).

[36] 94-2 U.S.T.C. at 85,519. Each of the debtor-acquired corporations in this consolidated case ended up in bankruptcy. Both the bankruptcy and district courts in *Federated Department Stores* also held that, alternatively, the break-up fees were deductible under I.R.C. § 165 because the white knight transactions had been abandoned. 92-1 U.S.T.C. at 83,394; 94-2 U.S.T.C. at 85,521.

[37] *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), *rev'g* 105 T.C. 166 (1995).

In the *PNC Bancorp* case,[38] the question was whether a bank's costs, including internal salaries and benefits, as well as third-party payments, incurred for marketing, researching and originating loans having a term exceeding one year were deductible currently or must be capitalized. The Third Circuit reversed the Tax Court, holding that, on the finding that the bank's loan operations were its primary method of income production and that the expenses in question were "normal and routine" in the banking industry, the costs were deductible ordinary and necessary costs of the banking business.

The next major post-*INDOPCO* case was the *Wells Fargo* case,[39] involving the deductibility of internal officers' salaries and legal and investigatory costs paid by the acquired corporation in a friendly acquisition. The Tax Court held that, under *INDOPCO*, all those costs must be capitalized because the acquisition was friendly and provided long-term benefits to the taxpayer, rejecting the taxpayer's arguments that, under *Briarcliff Candy*,[40] those expenses should be deductible as the costs of investigating whether to expand an existing business. The Eighth Circuit reversed in part, holding that the officers' salaries were, in any event, currently deductible because, under the "origin of the claim" doctrine, they had only an indirect relation to the acquisition but had a direct relation to the regular employment relationship.[41] As to the legal and investigatory or "due diligence" costs, the Court determined that their direct relationship to the acquisition was a factual question that depended on when the "final decision" to enter into the transaction had been made and for which a bright-line test would therefore be inappropriate. The court held that such expenses were deductible when incurred prior to the final decision to enter into the transaction, but had to be capitalized when incurred after the final decision.

The government had conceded on the appeal from the Tax Court in this case that the legal/investigatory expenses were deductible to the extent incurred prior to the "final

---

[38] *PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998).

[39] *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *rev'g Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999).

[40] *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973).

[41] Citing to: *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Deputy v. DuPont*, 308 U.S. 488 (1940); T.A.M. 954003 (June 30, 1995); P.L.R. 9326001 (March 18, 1993); T.A.M. 9527005 (March 15, 1995); T.A.M. 9721002 (Jan. 24, 1997); and T.A.M. 9731001 (Jan. 31, 1997).

decision," and both parties argued that the principles of Rev. Rul. 99-23[42] applied to determine when the final decision had occurred. In Rev. Rul. 99-23 (which had been issued after the Tax Court decision), the Service examined what expenditures qualify as investigatory costs that are eligible start-up costs that can be amortized under Section 195. The *Wells Fargo* court agreed that the ruling was pertinent because an eligible cost under Section 195 must be an expense that would be deductible under Section 162 if incurred by an existing business. In the ruling, the Service determined that investigatory expenses that are related to "*whether* to acquire a business" and "*which* business to acquire" are properly deductible under Section 162; on the other hand, once the "whether" and "which" questions have been answered, and the "final decision" is made to acquire a particular business, then any further "investigatory" expenses become expenses attributable to "facilitating" the consummation of the acquisition and are not deductible. The court determined that in the case at hand the final decision was the date the acquiring and acquired companies executed the agreement and plan of reorganization (the same date, incidentally, that the boards of both companies approved the transaction).[43]

In the *Lychuk* case,[44] the Tax Court, consistent with its decision in *PNC Bancorp*, rejected the origin of the claim analysis employed by the respective circuit courts in that case and in *Wells Fargo.* The court required the capitalization of expenses, including internal salaries, attributable to contracts that were actually acquired by a taxpayer whose sole business was the acquisition and servicing of automobile installment contracts. The court so held, notwithstanding the regular and recurring nature of those costs, because they were, in its view, directly related to the acquired contracts. Costs attributable to contracts not acquired were held to be currently deductible as were all overhead costs, which the court found not to be directly related to the acquisition of the contracts.

---

42 Rev. Rul. 99-23, 1999-1 C.B. 998.

43 224 F.3d at 889.

44 *Lychuk v. Commissioner*, 116 T.C. 374 (2001). *Lychuk* was not appealed.

In the *U.S. Freightways* case,[45] the Seventh Circuit, reversing the Tax Court, held that an accrual basis taxpayer's regular and recurring annual prepayments for various licenses, fees, permits and insurance premiums accrued at various times during the taxable year but that produced benefits of exactly 12 months (although a part extended into the next taxable year) were currently deductible. The government argued that the future benefits from the annual prepayments were not merely incidental and that they extended substantially beyond the taxable year so that they must be capitalized under *INDOPCO*. The taxpayer argued that a "one-year" rule existed under the common law of taxation. The Seventh Circuit (as did the Tax Court) rejected the existence of such a one-year rule but (unlike the Tax Court) determined that the prepayments were ordinary, necessary, recurring, of a short and limited life and not related to another asset.

C. 2002 ANPRM. A decade after *INDOPCO,* in early 2002, the Service issued an advance notice of proposed rulemaking[46] (the "ANPRM") describing a proposed new approach to the treatment of expenditures incurred to acquire, create or enhance intangible assets. The stated goals of the new approach were to provide greater certainty to taxpayers and to the Service regarding the application of the capitalization rules and to reduce the administrative and compliance costs associated with those rules. Generally, the ANPRM identified categories of expenditures that would be required to be capitalized if paid or incurred in connection with the acquisition, creation or enhancement of an intangible asset, and sought public comment on a number of issues raised by that approach and on the treatment of specific items.

D. Proposed Regulations. In late 2002, the Treasury and the Service published proposed regulations[47] (the "Proposed Regulations") that sought to implement

---

[45] *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137 (7th Cir. 2001), *rev'g* 113 T.C. 329 (1999).

[46] 67 Fed. Reg. 3461 *et seq.* (Jan. 24, 2002). Earlier, in Notice 96-7, 1996-6 I.R.B. 22, the Service had invited public comment on approaches the government should consider to address issues under I.R.C. §§ 162 and 263 in light of *INDOPCO*. In response, a coalition of businesses calling itself the "INDOPCO Coalition" submitted a broad scheme of capitalization principles for consideration by the Treasury (some of which were eventually adopted by the Final Regulations). *See* The INDOPCO Coalition, *Proposed Capitalization Principles*, 2001 TNT 198-42, 2001 TNT 198-44 (Oct. 12, 2001), *supplemented*, 2002 TNT 80-38 (April 25, 2002).

[47] REG–125638–01, 67 Fed. Reg. 7701, 77712 *et seq.* (Dec. 19, 2002).

and elaborate the principles set forth in the ANPRM and that responded to the public comments received. The preamble to the Proposed Regulations[48] ("Prop. Reg. Preamble") solicited public comments on issues not yet then resolved.[49]

E. Final Regulations. On December 31, 2003, the Treasury and the Service released final regulations (the "Final Regulations").[50] The Final Regulations are generally effective on that date. The preamble to the Final Regulations ("Preamble")[51] informs that both the formatting and the content of the Final Regulations were modified in response to extensive public comments on the Proposed Regulations.[52]

II. The Final Regulations – Summary of Principal Features Directed at Resolving Post-*INDOPCO* Controversies. The Final Regulations embrace two fundamental principles that reflect the laudable objective of avoiding continuing conflict between the government and taxpayers: simplicity and certainty. Following are some of the principal

---

[48] 67 Fed. Reg. 77701–77711 (Dec. 19, 2002).

[49] Numerous public comments were received in respect of the Proposed Regulations. *See, e.g.,* NEW YORK STATE BAR ASSOCIATION TAX SECTION, *Report on Notice of Proposed Rulemaking on Deduction and Capitalization of Expenditures Relating to Intangibles (Report No. 1031)*, 24, 25 (March 25, 2003); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *Comments on Proposed Regulations Providing Guidance Regarding Deduction and Capitalization of Expenditures*, 22–23 (April 21, 2003); ERNST & YOUNG LLP, *Comments on Proposed Regs. On Capitalizing Costs of Intangibles*, 2003 TNT 80-16 (April 25, 2003); PRICEWATERHOUSE COOPERS LLP, Comments on Proposed Regulations Regarding Capitalization of Expenditures to Create, Acquire, or Enhance Intangible Assets (letter dated April 22, 2003); AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, Comments on Proposed Regulations Regarding Deduction and Capitalization of Intangible Asset Expenditures (letter dated April 25, 2003); INDOPCO COALITION, Comments on Proposed Regulations Under Section 263(a) (letter dated July 7, 2003); AMERICAN BANKERS ASSOCIATION, Comments on Proposed Regulations Regarding Deduction and Capitalization of Expenditures (letter dated March 20, 2003); MAYER, BROWN, ROWE & MAW, Proposed Regulations on Deduction and Capitalization of Expenditures – Spinoff Expenses (letter dated March 18, 2003); TXU CORP., Notice of Proposed Rulemaking – Guidance Regarding Deduction and Capitalization of Expenditures (letter dated March 19, 2003); INVESTMENT COMPANY INSTITUTE, Proposed Regulations on Capitalization of Costs Under Section 263(a) (letter dated March 19, 2003); Calvin H. Johnson, UNIVERSITY OF TEXAS LAW SCHOOL (letter dated March 19, 2003); AMERICAN PETROLEUM INSTITUTE, Comments on Guidance Regarding Deductions and Capitalization of Expenditures Intangible Assets (letter dated March 18, 2003); IVINS, PHILLIPS & BAKER, Comments on Proposed Regulations under Section 263(a) – Guidance Regarding Deductions and Capitalization of Expenditures (letter dated March 14, 2003); GRANT THORNTON LLP, Comments on the Proposed Regulations Regarding Amounts Paid to Acquire, Create, or Enhance Intangibles (letter dated March 19, 2003).

[50] T.D. 9107 (Dec. 31, 2003), 69 Fed. Reg. 436 (Jan. 5, 2004).

[51] 69 Fed. Reg. 436-444 (Jan. 5, 2004).

[52] Preamble, at 69 Fed. Reg. 436. This article does not purport to discuss every feature of the Final Regulations, which is beyond its scope.

post-*INDOPCO* controversies that the Final Regulations seek to resolve.[53]

A. Business Expansion. The "future benefit" test is rendered inapplicable unless and until specific prospective future guidance is published. Any "separate and distinct intangible asset" that is purported to be created (or enhanced) must be a property interest that can be valued, that is legally protected and that is intrinsically capable of being sold, transferred or pledged separate and apart from a trade or business. Also, an expenditure made with the mere hope or expectation of developing or maintaining a business relationship with a party is not capitalizable if it is not contingent on the origination, renewal or renegotiation of a financial interest with that party. Further, computer software development costs, package design development costs, product launch costs and stock-lifting costs are specifically not capitalizable.

B. Operating Costs/Transactional Costs. Employee compensation, overhead and *de minimis* costs are never capitalizable, regardless of any connection to a capital transaction.

C. Short-Term Benefits. Under a 12–month rule, expenditures that create a short-term benefit are not capitalizable.

D. Business Integration Costs. Business integration costs are not capitalizable, regardless of any future benefit and of connection to a capital transaction.

E. Hostile Takeover Defense Costs. Hostile takeover defense costs are currently deductible.

F. Standstill Payments. Standstill payments must be capitalized.

G. Break-Up Fees. Break-up fees are currently deductible (unless the two transactions are "mutually exclusive").

[53] Not all of the innovations in the Final Regulations have been met with universal acclaim. *See, e.g.,* Lee A. Sheppard, *More Giveaways in Final Intangible Capitalization Rules,* 102 TAX NOTES TODAY 12 (2004).

H. Investigatory/Due Diligence Costs for Acquisitive Transactions. Investigatory and other due diligence costs for certain acquisitive transactions are currently deductible if incurred before a clearly defined bright-line date and must be capitalized after that date. Certain "inherently facilitative" costs must always be capitalized, however.

III. The Final Regulations – Overview.

A. Structure. The Final Regulations are comprised of four parts: Reg. § 1.167(a)–3(b) (safe harbor amortization for certain intangible assets); Reg. § 1.263(a)–4 (amounts paid to acquire or create intangibles); Reg. § 1.263(a)-5 (amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity and certain other transactions); and Reg. § 1.446–5 (debt issuance costs).

1. Capitalization Rules – Intangibles – Reg. § 1.263(a)-4. There are five categories of "intangibles" that must be capitalized under the Final Regulations. Underpinning the Final Regulations is the core principle of Section 263(a) of the Code that an amount paid to (i) "acquire" or to (ii) "create" an intangible asset must be capitalized.[54] The Final Regulations then deal separately with amounts paid to (iii) create or enhance a "separate and distinct intangible asset,"[55] to (iv) create or enhance a "future benefit,"[56] and to (v) "facilitate … an acquisition or creation of an intangible,"[57] *i.e.*, intangible transaction costs.

---

[54] Reg. § 1.263(a)–4(b)(i), (ii). Under the Final Regulations, the terms "amount paid" and "payment" mean, in the case of an accrual basis taxpayer, a liability incurred (within the meaning of Reg. § 1.446–1(c)(1)(ii)), and, under the Final Regulations, "a liability may not be taken into account prior to the taxable year in which the liability is incurred." Reg. §§ 1.263(a) –4(j), 1.263(a)-5(h). With the exception of rules requiring the capitalization of amounts paid for real property relinquished to another, or amounts paid to produce or improve real property owned by another, if the real property can reasonably be expected to produce significant economic benefits for the taxpayer, Reg. § 1.263(a)–4(d)(8), the Final Regulations do not apply to amounts paid to acquire or create *tangible* assets. Reg. § 1.263(a)–4(a). The Preamble explains, however, that bifurcating the transaction cost capitalization rules between §§ 1.263(a)-4 and 1.263(a)-5 "enabled the IRS and Treasury Department to apply some of the simplifying conventions in the proposed regulations to certain acquisitions of tangible assets." Preamble, at 69 Fed. Reg. 436.

[55] Reg. § 1.263(a)-4(b)(1)(iii), (b)(3).

[56] Reg. § 1.263(a)-4(b)(1)(iv).

[57] Reg. § 1.263(a)-4(b)(1)(v), (e).

2. Capitalization Rules – Business Acquisition and Capital Change Transaction Costs – Reg. § 1.263(a)-5. The Final Regulations incorporate an entire new section (§ 1.263(a)-5) devoted exclusively to transaction costs of acquisitions of a trade or business (including tangible assets), a change in the capital structure of a business entity and other capital-related entity transactions. Transaction costs associated with the acquisition or creation of all other intangibles remain in the section devoted exclusively to intangibles (§ 1.263(a)-4).[58]

3. Safe Harbor Amortization – Reg. § 1.167(a)-3(b). The safe harbor amortization provisions under section 167(a) provide a 15–year or 25–year safe harbor amortization period applicable to certain *created* intangible assets (other than created financial interests) that do not have useful lives that can be estimated with reasonable accuracy and for which an amortization period is not otherwise prescribed or prohibited by the Code, regulations or other published guidance.

4. Debt Issuance Costs – Reg. § 1.446-5. The debt issuance cost provisions under section 446 of the Code provide rules for allocating a borrower's debt issuance costs over the term of the debt by treating them as if they decreased the issue price of the debt, thus adjusting the yield on the debt and thereby increasing or creating original issue discount and decreasing or eliminating bond issuance premium.

B. Organization of Capitalization Rules for Intangibles – Reg. § 1.263(a)-4. The organization of the capitalization rules for the costs of intangibles under the Final Regulations reflects (i) the two principal means by which costs may be incurred by a taxpayer to generate ownership of an intangible asset (acquisition and creation), (ii) the treatment of related transaction costs and (iii) an exception for created intangible rights and benefits of brief duration (a "12–month rule").

1. Acquisition/Creation Costs. Different capitalization rules are provided depending on whether an intangible asset is generated by payment of amounts

[58] In the Proposed Regulations, all types of transaction costs were dealt with in a single subsection dealing only with intangible assets. Prop. Reg. § 1.263(a)-4(e).

to another person in connection with: (i) the acquisition of the intangible in a purchase,[59] or (ii) the creation of the intangible.[60]

2. Transaction Costs. Separate rules are then provided to determine whether and to what extent the transaction costs incurred to "facilitate" the acquisition or creation of the intangible are to be capitalized.[61] Included in those rules are "simplifying conventions" related to "employee compensation" and overhead and to *de minimis* costs.[62] The rules purposefully do not include a "regular and recurring" standard, however.[63]

3. 12–Month Rule. A "12–month rule" is adopted by the Final Regulations to reduce administrative and compliance costs. Under this rule, amounts paid to *create* (or to facilitate the creation of) intangible rights or benefits to the taxpayer that do not extend beyond the period prescribed by the 12–month rule are not required to be capitalized and may be deducted in the taxable year paid or incurred.[64]

C. The Five Categories of Intangibles. The Final Regulations, unlike the Proposed Regulations, do not attempt to define "intangible" or "intangible asset." Instead, the Final Regulations simply require the capitalization of the five categories of identified "intangibles" described above.[65]

1. Acquired Intangibles. A taxpayer must capitalize amounts paid to another party to *acquire* an intangible from that party in a purchase or similar transaction.[66] The Final Regulations provide a list of identified intangibles that, if

[59] Reg. § 1.263(a)–4(c).
[60] Reg. § 1.263(a)–4(d).
[61] Reg. § 1.263(a)–4(e). Transaction costs that are paid or incurred to facilitate the acquisition of a trade or business, a change in the capital structure of a business entity, including a restructuring or reorganization of a business entity or a transaction, involving the acquisition of capital, such as a stock issuance, borrowing or recapitalization, are dealt with separately in a different section. *See* Reg. § 1.263(a)-5, discussed *infra.*.
[62] Reg. § 1.263(a)-4(e)(4).
[63] Prop. Reg. Preamble, at 67 Fed. Reg. 77708.
[64] Reg. § 1.263(a)–4(f).
[65] Reg. § 1.263(a)-4(b)(1)(i)-(v). The definition attempted in the Proposed Regulations was itself tautological. *See* Prop. Reg. § 1.263(a)-4(b)(2)(i)(A)-(D).
[66] Reg. § 1.263(a)–4(c)(1).

acquired by the taxpayer in a purchase, must be capitalized.[67] The list is nonexclusive so that intangibles not listed, if acquired in a purchase, could be subject to capitalization. It is not clear whether such a nonlisted item would have to classified first as either a "separate and distinct" intangible asset or a "future benefit" identified prospectively in published guidance. The 12–month rule does not apply to *acquired* intangible assets.[68]

2. Created Intangibles. Unless excluded by the "12–month rule," a taxpayer must capitalize amounts paid to another party to *create* an intangible that is on an exclusive list of identified intangibles.[69] Because the list purports to be exclusive, it is not clear how the operation of the "separate and distinct" intangible category, which specifically refers to "an amount paid to create or enhance a separate and distinct intangible asset," or a "future benefit" identified prospectively in published guidance, will relate to this category.

The Preamble states that the categories of intangibles used in the Final Regulations will be construed broadly so that a taxpayer cannot make the narrow technical argument that an intangible created by the Taxpayer is not literally described in any of the categories.[70] The Final Regulations provide the basis for this interpretive rule with a statement that the determination of whether an amount is paid to create an intangible is to be made based on all the facts and circumstances, disregarding distinctions between the "labels" used to describe the exclusive list of created intangibles.[71]

3. Separate and Distinct Intangible Assets. Under the Final Regulations, a taxpayer must capitalize an amount paid to "create or enhance a separate and distinct intangible asset."[72] As a separate category of intangible that does not require future guidance for its operation (while the operation of the "future benefits" category does), this *Lincoln Savings* reservoir is designed to pick up the costs of created or

---

67 *Id*.
68 Reg. § 1.264(a)–4(f)(1).
69 Reg. § 1.263(a)–4(d)(1).
70 Preamble, at 69 Fed. Reg. 437.
71 Reg. § 1.263(a)-4(d)(1).
72 Reg. § 1.263(a)-4(b)(1)(iii).

enhanced intangibles that are not reflected in the exclusive list of created intangibles that is itself a separate category. The Final Regulations therefore resolve the *INDOPCO/Lincoln Savings* controversies in a pro-taxpayer manner.

First, the government has chosen to adopt as a general principle of capitalization the "separate and distinct asset" test and, effectively, to abandon as a general principle of capitalization the "significant future benefit" test adumbrated in *INDOPCO* for those categories of intangibles that are not specifically identified as capitalizable in the Final Regulations but which might later be classified as such. It is a policy of the intangible regulatory regime that, to the extent the significant future benefit principle has not already been incorporated into the specific categories of intangible assets identified in the Final Regulations, capitalization of the costs of creation of an intangible that is not on the exclusive created intangibles list will not be required merely because the intangible results in such benefit unless the intangible so classified is identified in future published guidance.[73] Rather, the question will be whether the expenditure in question has created or enhanced a separate and distinct intangible asset.

The Prop. Reg. Preamble expressed the policy considerations underlying the government's adoption of this position (initially in the Proposed Regulations) as follows:

> A fundamental purpose of section 263(a) is to prevent the distortion of taxable income through current deduction of expenditures relating to the production of income in future years. Thus, in determining whether an expenditure should be capitalized, the Supreme Court has considered whether the expenditure produces a significant future benefit. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). A "significant future benefit" standard, however, does not provide the certainty and clarity necessary for compliance with, and sound administration of, the

[73] Preamble, at 69 Fed. Reg. 436. The Prop. Reg. Preamble makes it clear that the significant future benefit test was, in fact, incorporated into the Proposed Regulations (and therefore into the Final Regulations, which did not modify this) insofar as that standard underlies many of the specific categories of intangibles for which capitalization is required, as well as in respect of the capitalization requirements

> law. Consequently, the IRS and Treasury Department have initially defined the exclusive scope of the significant future benefit test through the specific categories of intangible assets for which capitalization is required in the proposed regulations. The future benefit standard underlies many of these categories.[74]

The Prop. Reg. Preamble further clarified that the term "separate and distinct tangible asset" is based on "factors traditionally used by the courts to determine whether an expenditure serves to acquire, create, or enhance a separate and distinct asset." The Prop. Reg. Preamble observed that courts have considered (1) whether the expenditure creates a distinct and recognized property interest subject to protection under state or federal law; (2) whether the expenditure creates anything transferable or salable; and (3) whether the expenditure creates anything with an ascertainable and measurable value in money's worth.[75] The Final Regulations do not change the basis for the definition. Thus, a "separate and distinct intangible asset" is defined both in the Final and the Proposed Regulations as "a property interest of ascertainable and measurable value in money or money's worth that is subject to protection under applicable state or federal law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) *separate and apart from a trade or business*."[76]

Second, as to the separate and distinct intangible asset category, the Final Regulations (as did the Proposed Regulations) specifically state that amounts paid to another party to create or originate an agreement with that party that produces rights or benefits for the taxpayer do not create a separate and distinct intangible asset;[77]

---

imposed on transaction costs. Prop. Reg. Preamble, at 67 Fed. Reg. 77702, 77705 – 77706. The Preamble confirms this, at 69 Fed. Reg. 436-437.

[74] Prop. Reg. Preamble, at 67 Fed. Reg. 77702.

[75] *See Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 355 (1971); *Central Texas Savings & Loan Ass'n v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984); *Colorado Savings National Bank v. United States*, 505 F.2d 1185, 1192 (10th Cir. 1974); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 784 (2d Cir. 1973). Prop. Reg. Preamble, at 67 Fed. Reg. 77702.

[76] Reg. § 1.263(a)-4(b)(3)(i); Prop. Reg. § 1.263(a)–4(b)(2)(i)(C). The Final Regulations added the italicized clarifying language. The Final Regulations also clarify that a fund or (similar account) that may revert to the taxpayer is treated as a separate and distinct intangible asset. Reg. § 1.263(a)-4(b)(3)(i).

[77] Reg. § 1.263(a)-4(b)(3)(ii); Prop. Reg. § 1.263(a)–4(b)(3)(ii).

moreover, amounts paid to another party to terminate an agreement with that party do not create a separate and distinct intangible asset.[78] Instead, as discussed further below, the Proposed Regulations specifically identified (and thereby limited) those circumstances in which amounts paid for either such purpose must be capitalized, seeking thereby to eliminate any uncertainty about capitalization requirements in this category,[79] and those rules, discussed below, have been expanded and incorporated into the Final Regulations.[80]

Third, the Final Regulations further limit the application of the separate and distinct intangible asset definition in three circumstances. An amount paid to create a package design, computer software or an income stream from the performance of services under a contract is not treated as an amount that creates a separate and distinct intangible asset.[81] Also, the Final Regulations clarify that "product launch" costs and "stocklifting" costs do not create a separate and distinct intangible asset.[82]

4. Future Benefits. By creating a separate intangible category requiring capitalization of the costs to create or enhance a future benefit, but only if identified prospectively in future published guidance, the government has left open such a possibility. The relegation of the future benefit category exclusively to future published guidance purposefully seeks to eliminate all of the uncertainty created by the Service's aggressive auditing and litigating positions post-*INDOPCO* regarding the capitalization of traditionally deductible costs that arguably create a future benefit. The Prop. Reg. Preamble further elaborated the underlying policy considerations:

> The IRS and Treasury Department recognize, however, that there may be expenditures that are not identified in these [specifically identified] categories, but for which capitalization is nonetheless appropriate. For this reason, the proposed regulations

---

78 *Id.*

79 *See* Prop. Reg. § 1.263(a)–4(d)(2)(i)(C)(6), (2)(i)(C)(7), (6), (7); Prop. Reg. § 1.263(a)–4(e)(1)(ii).

80 *See* Reg. § 1.263(a)-4(d)(2)(i)(C)(6), (2)(i)(C)(7), (6), (7); Reg. § 1.263(a)-4(e)(1)(ii).

81 Reg. 1.263(a)-4(b)(3)(iii), (iv), (v). A "package design" is the "specific graphic arrangements or design of shapes, colors, words, pictures, lettering and other elements on a given product package, or the design of a container with respect to its shape or function." Reg. § 1.263(a)-4(b)(3)(v).

82 Reg. § 1.263(a)-4(l), *Examples 7, 8*.

require capitalization of non-listed expenditures if those expenditures serve to produce future benefits that the IRS and Treasury Department identify in published guidance as significant enough to warrant capitalization. A determination in published guidance that a particular category of expenditures produces a benefit for which capitalization is appropriate will apply prospectively, and will not apply to expenditures incurred prior to the publication of such guidance.

For purposes of future guidance, the IRS and Treasury Department will determine whether capitalization is appropriate for a particular category of expenditures by taking into account all relevant facts and circumstances, including the probability, measurability, and size of the expected future benefit. Such published guidance may provide a safe harbor amortization period for any expenditure required to be capitalized. If the published guidance does not provide a safe harbor amortization period, the expenditure may be eligible for the 15–year safe harbor amortization period described in … this preamble.

The IRS and Treasury Department believe that, by applying the significant future benefit test in the manner described above, the proposed regulations will substantially reduce the burden on both taxpayers and IRS field personnel of determining whether an expenditure produces significant future benefits for which capitalization is required. If an expenditure is not described in one of the categories in the proposed regulations or in subsequent future guidance, taxpayers and IRS field personnel need not determine whether that expenditure produces a significant future benefit.[83]

[83] Prop. Reg. Preamble, at 67 Fed. Reg. 77702 – 77703.

This approach was not changed by the Final Regulations. The Preamble confirms that the effect of any such published future guidance will be prospective only.[84]

5. Transaction Costs – Intangibles. As detailed below, amounts that "facilitate" an acquisition or creation of an intangible must be capitalized.[85]

D. Clear Reflection of Income. The Preamble notes that "commentators questioned how the regulations interact with the clear reflection of income requirement of Section 446(b) and whether the IRS would argue that an expenditure that is not required to be capitalized by the regulations should nonetheless be capitalized on the ground that the deduction of the expenditure does not clearly reflect income under section 446." The IRS disclaims this possibility, stating that, in any such event, "the IRS will not argue" to such effect.[86]

In the Proposed Regulations the government specifically refused to incorporate a "regular and recurring" rule into the regulatory scheme. The Final Regulations did not alter that policy.[87]

E. Coordination with other Code Provisions. The Final Regulations make clear the precedence of other Code provisions that specifically provide for the tax treatment of the item in question.[88] The Preamble gives as examples the treatment of an insurance company's policy acquisition expenses under Sections 848 and 197(f)(5) and research and experimentation expenditures that are deductible under Section 174.[89] The Final Regulations themselves provide as an example a "yield adjustment fee" payable under an interest rate swap agreement (treated as a notional principal contract under Reg. § 1.446-3(c)) that would be capitalizable as a created intangible under the Final Regulations but which is, instead, to be governed by Reg. § 1.446-3.[90]

---

[84] Preamble, at 69 Fed. Reg. 436.
[85] Reg. § 1.263(a)-4(b)(v), (e). *See also* Reg. § 1.263(a)-5.
[86] Preamble, at 69 Fed. Reg. 437.
[87] *See* Prop. Reg. Preamble, at 67 Fed. Reg. 77708.
[88] Reg. § 1.263-4(b)(4)(i).
[89] Preamble, at 69 Fed. Reg. 437.
[90] Reg. § 1.263(a)-4(b)(4)(ii).

F. Treatment of Capitalized Costs – Basis and Amortization. Costs that are required to be capitalized under Reg. § 1.263(a)-4 (including related transactions costs) are capitalized to the basis of the intangible asset acquired or created.[91] Other than the safe harbor amortization rules and the debt issuance cost rules, the Final Regulations do not govern the tax amortization of capitalized intangible costs.[92]

Acquisition costs and creation costs that are capitalizable to the basis of the intangible are either not recoverable until the intangible is disposed of or are recoverable under Section 197 or under another Code provision, such as Section 167 (Reg. § 1.167(a)–3(a) and Reg. § 1.167(a)–14), Section 162 (Reg. § 1.162–11), Section 171 and Section 178.[93]

The 15–year straight-line safe harbor amortization rule of the Final Regulations applies only to *created* intangible assets other than created financial interests and other than those that have prescribed lives or lives that can be reasonably estimated, and *not* to acquired intangibles.[94] Under both the 15–year and 25–year safe harbor amortization rules, the depreciation method is straight-line without regard to salvage value.[95] The 25–year straight-line safe harbor amortization rule applies only to the *created* intangible arising out of amounts paid for *real property* relinquished to another, or amounts paid to produce or improve *real property* owned by another, if the real property can reasonably be expected to produce significant economic benefits for the taxpayer.[96]

The Prop. Reg. Preamble points out that the 15–year safe harbor period is consistent with the 15–year amortization period prescribed by Section 197 and that a shorter period, such as the 60–month period allowed for start-up expenditures under Section 195, and organization expenditures under Sections 248 and 709, were not

---

91 Reg. § 1.263(a)–4(g).

92 Under the debt issuance cost rules of the Final Regulations, transaction costs in a borrowing (debt issuance costs) are recovered over the term of the debt as original issue discount or reduction of bond issuance premium (by reduction of the issue price). Reg. § 1.446–5.

93 *See* Prop. Reg. Preamble, at 67 Fed. Reg. 77709 – 77710.

94 Reg. § 1.167(a)–3(b)(1)(i), (ii), (iii).

95 Reg. § 1.167(a)–3(b)(3).

96 Reg. § 1.167(a)–3(b)(1)(iv); Reg. § 1.263(a)-4(d)(8).

adopted because to do so would "create tension with section 197 and might encourage attempts to circumvent the provisions of section 197."[97]

G. 12-Month Rule. Under Sections 263(a), 446 and 461 of the Code, payments that create an asset having a useful life substantially beyond the end of the taxable year of payment must be capitalized.[98] The courts have sometimes interpreted this rule to require a capitalized asset to have a useful life of at least 12 months.[99] The Final Regulations (as did the Proposed Regulations) adopt a form of "12–month rule" in order to "reduce the administrative and compliance costs inherent in applying Section 263 to amounts paid to create or enhance intangible assets."[100]

1. In General. Under the Proposed Regulations, amounts, including transaction costs, paid to create (or facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the *earlier* of (i) 12 months after the first date on which the taxpayer realizes a benefit or (ii) the end of the taxable year following the year in which the payment is made, are not required to be capitalized.[101] The 12–month rule, however, does not permit a taxpayer to accelerate the deduction of items for which economic performance has not occurred.[102]

2. Exceptions. The 12–month rule does not apply to amounts paid to create financial interests (*e.g.*, loans, options) or to self–created Section 197 intangibles as defined in Section 197(c).[103]

3. Contract Terminations. An amount paid to terminate a contract before its expiration date creates a benefit equal to the remaining term of the contract.[104]

---

[97] Prop. Reg. Preamble, at 67 Fed. Reg. 77709.
[98] Reg. §§ 1.263(a)–2(a), 1.446–1(c)(1)(i), 1.461–1(a)(2)(i).
[99] *U.S. Freightways Corp. v. Commissioner,* 270 F.2d 1137 (7th Cir. 2001), *rev'g* 113 T.C. 329 (1999); *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980). *See, generally,* W. Eugene Seago & Edward J. Schnee, *IRS Loses on Appeal, and Announces There Should Be a One-Year Rule for Prepaid Expenses,* 96 J. TAX. 153 (2002).
[100] Prop. Reg. Preamble, at 67 Fed. Reg. 77707.
[101] Reg. § 1.263(a)–4(f)(1), (2). Thus, by its terms, the 12–month rule does not apply to amounts paid to *acquire* any intangible.
[102] Reg. § 1.263(a)–4(f)(7); *see* Reg. § 1.263(a)–4(f)(8), *Examples 10, 11*.
[103] Reg. § 1.263(a)–4(f)(3).
[104] Reg. § 1.263(a)–4(f)(2).

LAS99 1319819-1.009900.0021

Thus, an amount paid to terminate a contract with less than a 12–month remaining term will be subject to the 12–month rule and immediately deductible. The Final Regulations clarify that if a taxpayer is permitted to terminate an agreement after a notice period, in determining whether the 12-month rule applies, amounts paid to terminate the agreement before the end of the notice period create a benefit for the taxpayer that lasts for the amount of time by which the notice period is shortened.[105] A provision in the Proposed Regulations to the effect that the mere fact that a right is terminable at will by either party does not automatically bring it within the 12–month rule[106] does not appear in the Final Regulations, probably for the reason that such a rule is subsumed in the rule regarding termination prior to the end of a required notice period for termination.[107]

4. Indefinite Rights. The 12–month rule does not apply to rights of indefinite duration (that is, a right that does not expire either by its terms or by operation of law, or that is not based on a period of time).[108]

5. Renewable Rights. In determining whether the 12–month rule applies to renewable contracts that, but for the renewal right, would be subject to the 12–month rule, the taxpayer must determine whether there is a "reasonable expectancy" of renewal. If there is such an expectancy, and renewal would extend the contract beyond the period to which the 12–month rule applies, the 12–month rule will not apply.[109]

a. Factors. The Final Regulations set out a list of factors, which are apparently not exclusive, that are "significant" in determining whether there is a "reasonable expectancy of renewal." These include the renewal history of similar rights, whether renewal is necessary for the taxpayer to earn back its investment, whether there is evidence that indicates the likelihood of renewal by the other party, such as the existence of a bargain renewal right or similar arrangement (but not the right to renew on

---

105 *Id.* Preamble, at 69 Fed. Reg. 440.

106 Prop. Reg. § 1.263(a)–4(f)(6).

107 Reg. § 1.263(a)-4(f)(2).

108 Reg. § 1.263(a)–4(f)(4). The Prop. Reg. Preamble points out that Reg. § 1.167(a)–14(c) provides rules for amortizing costs to obtain a right to receive a fixed amount of property or services (multiplying the basis of the right by a fraction, the numerator of which is the amount of tangible property or services received during the taxable year and the denominator of which is the total amount of tangible property or services received or to be received under the contract). Prop. Reg. Preamble, at 67 Fed. Reg. 77708.

the same terms that are available to others following a process intended to reflect fair market value) and whether the terms of renewal are subject to renegotiation.[110] The fact that the material terms of a right are subject to renegotiation at the end of the initial term is evidence of a lack of reasonable expectancy of renewal.[111]

b. Pools. As an alternative to a right–by–right determination of whether there is a reasonable expectancy of renewal, the Final Regulations provide for a pooling method under which similar rights are pooled but only for a taxpayer that reasonably expects to enter into at least 25 similar rights during the taxable year.[112] All non-*de minimis* amounts paid to create (or facilitate the creation) of the rights included in the pool are aggregated. If less than 20% of the rights in a pool are reasonably expected to be renewed, then none of the rights is considered to have a duration that exceeds the 12–month rule. On the other hand, if more than 80% of rights in a pool are reasonably expected to be renewed, then all of the rights are considered to have a duration that exceeds the 12–month rule. If 20% or more, but 80% or less, of the rights in the pool have such an expectancy, then the total costs attributable to the pool are to be multiplied by the percentage of the rights that have such expectancy; that amount of costs is required to be capitalized and the balance is allowed as a deduction.[113]

6. Election to Capitalize. The Final Regulations add a provision allowing taxpayers to elect *not* to apply the 12-month rule and thus to capitalize amounts otherwise subject to the rule.[114] The election applies to all "similar transactions" during the taxable year. "For example, a taxpayer may elect … to capitalize its costs of prepaying insurance costs for 12 months, but may continue to apply the [12-month] rule … to its costs of entering into non-renewable, 12-month service contracts.[115] The Preamble explains that "…some taxpayers may capitalize amounts for financial

---

109 Reg. § 1.263(a)–4(f)(5)(i).
110 Reg. § 1.263(a)–4(f)(5)(ii).
111 Reg. § 1.263(a)–4(f)(5)(ii)(D).
112 Reg. § 1.263(a)-4(f)(5)(iii).
113 Reg. § 1.263(a)–4(f)(5)(iii)(A)-(D).
114 Reg. § 1.263(a)-4(f)(7).
115 *Id.* The election is made on the timely filed return for the taxable year of the payment; in a consolidated group it must be made separately for each member; for a partnership or S corporation it must be made by the entity. The election cannot be revoked without I.R.S. consent. *Id.*

accounting purposes that would not be required to be capitalized for federal income tax purposes due to the 12-month rule. For this reason the Final Regulations permit taxpayers to elect to capitalize these amounts…."[116]

IV. The Final Regulations – Acquired and Created Intangibles.

A. Acquired Intangibles. The Final Regulations (as did the Proposed Regulations) create a nonexclusive category of *acquired* intangible assets for which the amounts paid to another party to *purchase* the intangible must be capitalized.[117] Items on the acquired intangibles list are set forth in the Final Regulations as nonexclusive examples:

1. Ownership Interests. Ownership interests in legal entities (such as a corporation, partnership, trust, estate, limited liability company or "other similar entity").[118] For example, an amount paid to purchase all the outstanding stock of a corporation W constitutes an amount paid to acquire an intangible in a purchase and must be capitalized.[119] The same result would occur if the amount had been paid to purchase from W a partnership interest, LLC interest or other legal entity interest owned by W.

Amortization Practice Point: Ownership interests in legal entities are not Section 197 intangibles[120] and their costs are not otherwise amortizable;[121] thus, the cost of the purchased ownership interest capitalized to basis is not recovered until the disposition of the interest.

2. Debt Instruments. A debt instrument (included within this category are a deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon[122]), regular interest in a REMIC or

---

116 Preamble, at 69 Fed. Reg. 440.
117 Reg. § 1.263(a)–4(c)(1); *see* Prop. Reg. § 1.263(a)-4(c)(1).
118 Reg. § 1.263(a)–4(c)(1)(i).
119 *See* Reg. § 1.263(a)–4(c)(4), *Example 3*.
120 Reg. § 1.197–2(c)(1).
121 Reg. § 1.167(a)–3(a): "An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation." Reg. § 1.167(a)–14(c): "Intangibles . . . excluded from section 197 are amortizable only if they qualify as property subject to the allowance for depreciation under section 167."
122 Under Rev. Rul. 91–46, 1992–2 C.B. 358, amounts received as fees or compensation under a mortgage servicing contract are treated as interest payments on stripped-bond coupons if (1) the mortgage

FASIT, or any other intangible treated as debt for federal income tax purposes).[123] Thus, if a commercial bank purchases a portfolio of existing loans from another financial institution, the amount paid for the portfolio constitutes an amount paid to acquire an intangible and must be capitalized.[124]

Amortization Practice Point: A debt instrument is not a Section 197 intangible.[125] Under the Final Regulations, purchase price is not a debt issuance cost,[126] so, except to the extent there is bond premium or market discount, the capitalized cost is not recovered until the instruments are paid or disposed of.[127] If a premium over the face amount of any loan in the loan portfolio is paid, the excess purchase price allocable to such debt obligation is amortizable at the election of the holder as an offset to the interest payable on the obligation, the effect of which is to reduce basis.[128] If any loan in the loan portfolio is acquired after original issuance at a discount from the stated redemption price at maturity, the discount allocable to such debt obligation is subject to the market discount bond rules, under which a holder may elect to include accrued market discount in gross income currently in lieu of treating gain on the disposition of the instrument as ordinary income.[129]

3. Financial Instruments. A financial instrument (included within this category are a notional principal contract, foreign currency contract, futures contract, forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property,

---

servicer entered into the service contract in connection with a sale of the mortgages being serviced, (2) the compensation amounts are taken from interest collected under the mortgages and (3) such amounts are determined to exceed reasonable compensation for the mortgage servicing services rendered. *See also* Rev. Proc. 91–49, 1991–2 C.B. 777; Rev. Proc. 91–50, 1991–2 C.B. 778; and Rev. Proc. 91–51, 1991–2 C.B. 779. Mortgage loans so treated as stripped bonds are subject to the original issue discount rules under I.R.C. § 1286.

[123] Reg. § 1.263(a)–4(c)(1)(ii).

[124] *See* Reg. § 1.263(a)–4(c)(4), *Example 1*.

[125] Reg. § 1.197–2(c)(9)(i). The acquisition of a financial institution's loan portfolio is to be distinguished from the acquisition of the deposit base made as part of the acquisition of the trade or business of the financial institution, in which case the deposit base would be treated as a customer-based intangible, and therefore as an amortizable § 197 intangible, under Reg. § 1.197–2 (b)(6), (c)(9)(ii).

[126] Reg. § 1.446–5(a).

[127] I.R.C. § 1271(a).

[128] I.R.C. § 171(b)(1)(ii), (e); Reg. § 1.1016–5(b).

[129] I.R.C. § 1276 – 1278.

regardless of whether the taxpayer provides or acquires the property)), option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, *regardless of whether the taxpayer provides or acquires the property*)) or any other "financial derivative").[130]

Example: X purchases a foreign currency contract from Y (that Y had earlier entered into with Z). The purchase price must be capitalized. *Amortization*: An interest in a financial instrument, including a foreign currency contract, is not a section 197 intangible.[131] The capitalized cost to basis is not amortizable and so is not recoverable until the disposition of the asset.[132] A portion of any gain or loss on disposition of a foreign currency contract might be treated as a foreign currency gain or loss.[133]

Example: X purchases an option from W to purchase all the outstanding stock of Z corporation, which W owns. The amount paid for the option must be capitalized. *Amortization*: An interest in a financial instrument, including an option, is not a Section 197 intangible.[134] The capitalized cost to basis is not amortizable and so is recoverable upon the disposition, cancellation, lapse, expiration or other termination of the option or is added to the stock basis when the option is exercised.[135]

4. Annuities, etc. An endowment contract, annuity contract or insurance contract that has or may have cash value.[136]

Example: X purchases an annuity contract from W that was originally issued to W by an insurance company. The amount paid to W must be capitalized. *Amortization*: Contracts for insurance, annuities and related products are not Section 197

[130] Reg. § 1.263(a)–4(c)(1)(iii)(A)-(F). The italicized language was added in each case by the Final Regulations. *See* Prop. Reg. § 1.263(a)-4(c)(1)(iii)(F), (G).
[131] Reg. § 1.197–2(c)(2).
[132] Reg. § 1.167(a)–3.
[133] I.R.C. § 988(a).
[134] Reg. § 1.197–2(c)(2).
[135] I.R.C. §§ 1234(a), 1234A(1).
[136] Reg. § 1.263(a)–4(c)(1)(iv).

intangibles.[137] The capitalized cost to basis is not amortizable but is recovered upon the disposition of the contract or the payment of the contract amount.[138]

5. Non-functional currency. Non-functional currency.[139]

Example: X purchases £5,000,000 from a foreign bank for $10,000,000. X's functional currency is the U.S. dollar. The $10,000,000 must be capitalized. *Amortization*: Non-functional currency is not a Section 197 intangible.[140] The capitalized cost to basis is not amortizable but is recovered upon the disposition of the currency or of the asset purchased with it.[141]

6. A lease. A lease.[142] The Prop. Reg. Preamble explained that, as a general rule, the Proposed Regulations are not intended to apply to a taxpayer's intangible interest in land. "Thus, the Proposed Regulations do not apply to amounts paid to acquire or create easements, life estates, mineral interests, timber rights or other intangible interests in land. An exception is made for amounts paid to acquire or create a lease of real property."[143] The Final Regulations do not modify this position.[144] The Prop. Reg. Preamble further stated that appropriate rules relating to the treatment of land will be addressed in future guidance to be issued in respect of the treatment of amounts paid to acquire, create, or enhance tangible assets.[145]

7. A patent or copyright. A patent or copyright.[146]

Example: X buys all right, title and interest to the widget patent, which was issued to, and is owned by, Y. The amount paid to Y must be capitalized. *Amortization*: A patent or copyright not acquired as part of the purchase of a business is

---

137 I.R.C. § 197(d).
138 I.R.C. § 72(g)(1); Reg. § 1.72–10.
139 Reg. § 1.263(a)–4(c)(1)(v).
140 I.R.C. § 197(d).
141 Reg. § 1.167(a)–3(a). *See* I.R.C. § 988(a).
142 Reg. § 1.263(a)–4(a)(c)(1)(vi).
143 Prop. Reg. Preamble, at 67 Fed. Reg. 77701.
144 Preamble, at 69 Fed. Reg. 437.
145 *Id.*
146 Reg. § 1.263(a)–4(c)(1)(vii).

not a Section 197 intangible.[147] The capitalized cost to basis is recovered ratably over the remaining life of the patent or copyright[148] or under the income forecast method.[149] A patent acquired as part of the purchase of a business, on the other hand, is an amortizable Section 197 intangible and the allocated cost under Section 1060 is therefore recoverable ratably over 15 years.[150]

8. A franchise, trademark or tradename. A franchise, trademark or tradename.[151]

Example: X opens a business and discovers that its tradename has been trademarked by W corporation. X pays an amount to W to purchase all right, title and interest to the trademark. The amount paid to W must be capitalized. *Amortization*: A franchise, trademark or tradename is an amortizable Section 197 intangible (even if not acquired in the acquisition of a business) and the capitalized cost to basis is therefore recoverable ratably over 15 years.[152] This is *not* the case if the amount paid is treated as a contingent royalty under a license agreement, in which case the payment is currently deductible under Section 162(a).[153]

9. An assembled workforce. An assembled workforce.[154]

Example: X purchases all the assets of Y, in a taxable transaction, for cash. The purchase price is allocable, in part, under Section 1060, to the assembled workforce in place of Y. The amount allocated to the assembled workforce must be capitalized. *Amortization*: The assembled workforce in place is an amortizable Section 197 intangible and the capitalized cost to basis is therefore recoverable ratably over 15 years.[155]

---

147 Reg. § 1.197–2(b)(5); Reg. § 1.197–2(c)(7).
148 Reg. § 1.167(a)–14(c)(4).
149 I.R.C. § 167(g).
150 Reg. § 1.197–2(b)(5); Reg. § 1.197–2(c)(7).
151 Reg. § 1.263(a)–4(c)(1)(viii).
152 Reg. § 1.197–2(b)(10)(i).
153 Reg. § 1.197–2(b)(10)(ii); I.R.C. § 1253(d)(1).
154 Reg. § 1.263(a)–4(c)(1)(ix).
155 Reg. § 1.197–2(b)(3).

10. Goodwill or going concern value. Goodwill or going concern value.[156]

Example: The facts are the same as in the preceding example with the additional fact that a portion of the purchase price is allocable under Section 1060 to goodwill and going concern value. That amount must be capitalized.[157] *Amortization*: Goodwill and going concern value are amortizable Section 197 intangibles and the capitalized cost to basis is therefore recoverable ratably over 15 years.[158]

11. A customer list. A customer list.[159]

Example: The facts are the same as in the preceding example with the additional fact that a portion of the purchase price is allocable under Section 1060 to a customer list created by the seller, Y. That amount must be capitalized.[160] *Amortization*: A customer list is an amortizable Section 197 intangible (information base) and the capitalized cost to basis is therefore recoverable ratably over 15 years.[161]

12. A servicing right. A servicing right; for example, a "mortgage servicing right."[162]

Example: Y has a contract with Z, a mortgage lender, under which Y services the mortgage loans made by Z to its customers. X pays Y an amount to acquire the servicing rights, to which transaction Z consents. The amount paid to Y must be capitalized. *Amortization*: A mortgage servicing right not acquired as part of the purchase of a trade or business is not a Section 197 intangible.[163] The capitalized cost to basis is therefore recoverable ratably over 108 months (nine years).[164] If the mortgage servicing right had been acquired as part of the purchase of X's trade or business, as in the preceding example, the asset's allocated purchase price under Section 1060 would be

---

156 Reg. § 1.263(a)–4(c)(1)(x).
157 *See* Reg. § 1.263(a)–4(c)(4), *Example 5*.
158 Reg. § 1.197–2(b)(1), (2).
159 Reg. § 1.263(a)–4(c)(1)(xi).
160 *See* Reg. § 1.263(a)–4(c)(4), *Example 4*.
161 Reg. § 1.197–2(b)(4).
162 Reg. § 1.263(a)–4(c)(1)(xii).
163 Reg. § 1.197–2(b)(6); Reg. § 1.197–2(c)(11).
164 Reg. § 1.167(a)–14(d).

the cost of an amortizable Section 197 asset and the capitalized cost to basis would therefore be recoverable ratably over 15 years.[165]

13. A customer-based intangible or a supplier-based intangible. A customer-based intangible or a supplier-based intangible.[166]

Example: X purchases all of the assets of Y, in a taxable transaction, for cash. One of the purchased assets is the existing customer base (a customer-based intangible, as defined in Reg. § 1.197–2(b)(6)), to which the purchase price is allocable in part under Section 1060. The amount so allocated must be capitalized. Similarly, among the purchased assets are the existing favorable supply contracts of Y (a supplier-based intangible, as defined in Reg. § 1.197–2(b)(7)), to which the purchase price is allocable in part under Section 1060. The amount so allocated must be capitalized. *Amortization*: Customer-based and supplier-based intangibles are amortizable Section 197 assets and the capitalized cost to basis in each case is therefore recoverable ratably over 15 years.[167]

14. Computer software. Computer software.[168]

Example: The facts are the same as in the preceding example with the additional fact that a portion of the purchase price is allocable under Section 1060 to non-”readily available” computer software acquired from Y. The amount so allocable must be capitalized.[169] *Amortization*: Computer software that is not “readily available” and that is acquired in the purchase of a trade or business is an amortizable Section 197 asset and the cost capitalized to basis is therefore recoverable ratably over 15 years.[170] If non-”readily available” computer software is acquired not in the purchase of a trade or business, but as a separate purchase, it is not a Section 197 asset and its capitalized cost is recovered ratably over 36 months.[171]

---

165 Reg. § 1.197–2(b)(6).
166 Reg. §1.263(a)–4(c)(1)(xiii).
167 Reg. §1.197–2(b)(6), (7).
168 Reg. § 1.263(a)–4(c)(1)(xiv).
169 *Id.*
170 Reg. § 1.197–2(b)(5); Reg. § 1.197–2(c)(4)(i).
171 Reg. § 1.197–2(c)(4)(ii); I.R.C. § 167(f); Reg. § 1.167(a)–14(b).

Amounts paid for "readily available software" must also be capitalized.[172] Such amounts include payments for a nonexclusive license for software that is (or has been) readily available to the general public on similar terms and has not been substantially modified (within the meaning of Reg. § 1.197–2(c)(4)). "Readily available" software is specifically excluded from the definition of a Section 197 intangible.[173]

Example: The facts are the same as in the preceding example except that the software is "readily available." The allocated cost of the acquired software must be capitalized. *Amortization*: Because the software is not a Section 197 intangible, the capitalized cost to basis is recoverable ratably over 36 months.[174] The same result would obtain for any computer software, whether or not "readily available," that is not acquired as part of the purchase of a trade or business.[175]

15. An agreement providing the right to use, possess or sell an intangible. An agreement providing either party the right to use, possess or sell an intangible constituting an ownership interest in an entity, a debt instrument, a financial instrument, an endowment, annuity or insurance contract or a non-functional currency.[176]

Example: X corporation and Y corporation are parties to an executory contract under which X has agreed to buy all of the stock of Z corporation, Y's subsidiary. X sells all its assets to R in a taxable transaction for cash. The amount paid by R is allocable in part to the executory contract under Section 1060 and must be capitalized. *Amortization*: The contract is not a Section 197 intangible.[177] If the contract is treated as an option, the capitalized cost is not amortizable and is therefore added to the basis of the stock upon its purchase.[178] If it is not treated as an option and it has a life that can be reasonably estimated, it is amortizable over that period.[179] If it has no

---

172 Reg. § 1.263(a)–4(c)(2).
173 Reg. § 1.197–2(c)(4)(1).
174 I.R.C. § 167(f); Reg. § 1.167(a)–14(b).
175 Reg. § 1.197–2(c)(4)(ii); Reg. §1.167(a)–14(b).
176 Reg. § 1.263(a)-4(c)(1)(xv). This new category was not included in the Proposed Regulations.
177 Reg. § 1.197-2(b)(11), (c)(1), (2).
178 I.R.C. §§ 1234, 1234A.
179 1.167(a)-3(a).

ascertainable life, the 15-year safe harbor amortization rule will apply.[180] Any unamortized balance upon purchase of the stock would then be added to the stock basis.

16. Amounts Paid to Employees. Amounts paid to an employee to *acquire* an intangible asset from that employee are not required to be capitalized if those amounts are treated as compensation for personal services includible in the employee's income under Section 61 or 83.[181] Amounts paid to acquire an intangible asset from an independent contractor, even if includible in the contractor's income under Section 61 or 83, are apparently not covered by the exclusion because the definition of employee for this purpose is by reference to Section 3401(c) of the Code, the provision relating to withholding at the source of income taxes from wages.[182] This resolves a long-standing issue in favor of taxpayers insofar as it relates to employees.

Example: Employer X has a policy (contained in an agreement that all employees must sign) that all employee inventions belong to X and that each inventor-employee will be paid a taxable bonus related to the value to X of the invention. The bonus is not capitalizable; nor is any part of the employees' regular or other compensation or benefits, and neither is any overhead of X attributable to employee inventions.[183]

B. Created Intangibles. The Final Regulations, as did the Proposed Regulations, set forth an exclusive list of created intangibles. The costs of *creating* those intangibles must be capitalized by the taxpayer.[184] Because the list is exclusive, costs of items not on it are not required to be capitalized if they are created by the taxpayer (unless an intangible so created is a "separate and distinct" intangible or is a "future benefit" prospectively identified as a capitalizable intangible in published guidance).

---

180 1.167(a)-3(b).

181 Reg. § 1.263(a)–4(c)(3).

182 *Id.*

183 *Id. See* Reg. § 1.263(a)–4(e)(4)(i) (compensation paid to employees and allocable overhead and *de minimis* costs are not treated as capitalizable transaction costs under the Final Regulations).

184 Reg. § 1.263(a)–4(d)(1); Prop. Reg. § 1.263(a)-4(d)(1). The use of the phrase "created or enhanced" in the Proposed Regulations has been modified in the Final Resolutions to delete the term "enhance." Instead, several of the categories of listed created intangibles were revised in the Final Regulations to more specifically identify the types of enhancements for which capitalization is required. *See* Preamble, at 69 Fed. Reg. 437.

The 15–year (or 25–year) safe harbor amortization period applies to capitalized created intangibles (other than financial interests) that do not have useful lives that can be reasonably estimated and for which an amortization period is not otherwise prescribed or prohibited.[185] The "12–month rule," described above, applies to most created intangibles.

The "financial interests" included in the acquired intangibles list are also on the created intangibles list, but none of the other items on the acquired intangibles list is on the created intangible list. Accordingly, for example, if a taxpayer incurs costs to *create* its own customer base (as opposed to paying an amount to *purchase* a customer base from a third party), the cost is not capitalized under Section 263(a).[186] The exclusive list follows.

1. <u>Financial Interests</u>. The five items from the acquired assets list that are included in the created intangibles list are all "financial interests." The 12–month rule does not apply to amounts paid to create a financial interest.[187] The 15–year safe harbor amortization period does not apply to amounts paid to create a financial interest.[188]

The Final Regulations require that a taxpayer capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the following "financial interests," whether or not the interest is regularly traded on an established market:[189]

a. <u>Ownership Interests</u>. Ownership interests. This category includes the same owner interests in legal entities appearing on the acquired intangibles list.[190]

---

185 Reg. § 1.167(a)–3(b).
186 Prop. Reg. Preamble, at 67 Fed. Reg. 77703.
187 Reg. § 1.263(a)–4(f)(3).
188 Reg. § 1.167(a)–3(b).
189 Reg. § 1.263(a)–4(d)(2)(i).
190 A corporation, partnership, trust, estate, limited liability company or other similar entity. Reg. § 1.263(a)–4(d)(2)(i)(A). *See* Reg. § 1.263(a)-4(c)(1)(i).

Example. Z corporation pays an amount to P, a partnership, in exchange for the issuance to P of an ownership (partnership) interest in P. The amount paid to P is an amount paid to another party to create an ownership interest in a partnership with that party and must be capitalized.[191] The same result would occur if Z had paid an amount to create (in exchange for the issuance to P of) an ownership interest in a corporation (stock), LLC (membership interest) or other legal entity. *Amortization*: Ownership interests are not section 197 intangibles, they are ineligible for safe harbor amortization under the Final Regulations and they are not otherwise amortizable; [192] thus, the cost of the created intangible capitalized to basis is not recovered until the disposition of the intangible (or, in the case of a pass-through entity, until net losses are passed through).

b. A Debt Instrument. This category includes the same types of debt instruments that are included in the acquired intangibles list. [193]

Example. X corporation, a commercial bank, makes a nine-month loan to A. The amount lent to A constitutes an amount paid to another party to create a debt instrument with that party and, because the 12–month rule does not apply to financial interests, it must be capitalized.[194] *Amortization*: A created debt instrument is not a section 197 intangible, it is ineligible for safe harbor amortization and it is not otherwise amortizable.[195] Thus, the cost of the created debt instrument capitalized to basis is not recovered until the debt is paid or until the disposition of the asset.[196]

---

191 *See* Reg. § 1.263(a)–4(d)(2)(iv), *Example 3*.

192 Reg. § 1.197–2(c)(1); Reg. § 1.167–3(b)(1)(ii); Reg. § 1.167(a)–3(a).

193 A deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes. Reg. § 1.263(a)–4(d)(2)(i)(B).

194 *See* Reg. § 1.263(a)–4(d)(2)(vi), *Example 1*; Reg. § 1.263(a)-4(f)(8), *Example 3*.

195 I.R.C. § 197(d); Reg. § 1.167–3(b)(1)(ii); Reg. § 1.167(a)–3(a).

196 There may be bond premium income (that is required to offset interest deductions) under I.R.C. § 61, Reg. §§ 1.61–12(c), 1.163–13, or deductible original issue discount under I.R.C. § 163(e), Reg. § 1.163–12.

c. Financial Instruments. Financial instruments. This category includes the same financial interests that are included in the acquired intangibles list, with two additions.[197]

The term "financial instrument" includes forward contracts and options. A "forward contract" includes, very broadly for this purpose, any agreement under which the taxpayer has the right and the obligation to provide or to acquire property (or to be compensated for such property), *regardless of whether the taxpayer provides or acquires the property*. Consistently, an "option" for this purpose includes any agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property), *regardless of whether the taxpayer provides or acquires the property*.[198] Under the Proposed Regulations, an amount was not required to be capitalized as the cost to create or enhance a contract or an option (as so defined), however, if the amount is allocable to property *required* to be provided or acquired by the taxpayer prior to the end of the taxable year in which the amount is paid.[199] This provision was removed from the Final Regulations.[200]

Example. W owns all the outstanding stock of X corporation, and Y pays W an amount for the issuance by W to Y of a nine-month call option against W permitting Y to purchase all the outstanding stock of X at an agreed price per share. The amount paid to W constitutes an amount paid to another party to create or originate an option with that party and, because the 12–month rule does not apply to financial interests, it must be capitalized.[201] *Amortization*: An interest in a financial instrument is not a Section 197 intangible.[202] The capitalized cost to basis is not amortizable and so is

---

[197] A letter of credit, credit card agreement, notional principal contract, foreign currency contract, forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property), option, (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property), and any other financial derivative. Reg. § 1.263(a)–4(d)(2)(i)(C)(1)-(8). Letters of credit and credit card agreements, while included in the acquired list under the Proposed Regulations, are not included under the Final Regulations. *See* Prop. Reg. § 1.263(d)-4(c)(1)(iii)(A), (B).

[198] Reg. § 1.263(a)–4(d)(2)(i)(C)(6), (7). The italicized language was added in each case by the Final Regulations. *See* Prop. Reg. 1.263(a)-4(d)(2)(i)(C)(6), (7).

[199] Prop. Reg. § 1.263(a)–4(d)(2)(ii).

[200] Preamble, at 69 Fed. Reg. 438.

[201] *See* Reg. § 1.263(a)–4(d)(2)(vi), *Example 2*; Reg. § 1.263(a)–4(f)(8), *Example 4*.

[202] Reg. § 1.197–2(c)(2).

recoverable upon the disposition, cancellation, lapse, expiration or other termination of the option or is added to the basis of the stock when the option is exercised.[203]

Example. Q, a natural gas producer, pays R an amount to induce R to enter into a five–year "take or pay" gas contract under which R is liable to pay for a fixed amount of gas, whether or not R actually takes delivery. The amount paid to R is capitalizable because it is paid to another party to induce that party to enter into an agreement providing Q, the taxpayer, the right and obligation to provide property or to be compensated for the property, regardless of whether the property is provided.[204] *Amortization*: The capitalized intangible is not a section 197 intangible because it is a self-created intangible and it is not subject to the 15–year safe harbor because it is a "financial interest" and, in any event, it has an ascertainable useful life. Accordingly, the capitalized cost to basis is recoverable ratably over the five–year contract period.[205]

Example. P pays R an amount to induce R to agree to purchase a fixed amount of P's product at any time within the next three calendar years. Although the agreement describes the amount paid to R as a "sales discount," it must be capitalized because it is in substance an amount paid to induce R to enter into an agreement providing P, the taxpayer, the right and obligation to provide property.[206] *Amortization*: As in the preceding example, the capitalized cost is amortizable ratably over the three-year contract term.[207]

Example. S, a computer manufacturer, agrees to pay V, as an incentive, an amount if V purchases a fixed number of units from S within three years on the date V's purchases reach that number of units. V does purchase the fixed number of units, and S pays V the incentive amount, in the third year. The amount paid is not required to be capitalized because the payment does not provide P with the right to

203 I.R.C. §§ 1234(a), 1234A(1).
204 *See* Reg. § 1.263(a)–4(d)(2)(vi), *Example 4*.
205 Reg. § 1.197–2(d)(2); Reg. § 1.163(a)–3(b)(ii), (iii); Reg. § 1.167(a)–3(a).
206 *See* Reg. § 1.263(a)–4(d)(2)(vi), *Example 5*.
207 Reg. § 1.197–2(d)(2); Reg. § 1.163(a)–3(b)(ii), (iii); Reg. § 1.167(a)–3(a).

LAS99 1319819-1.009900.0021

provide property. The example in the Final Regulations notes that the amount paid by S to V does not create or enhance a "separate and distinct" intangible asset.[208]

d. Annuities, etc. This category includes the same endowment contracts, annuity contracts and insurance contracts that have or may have cash value that are included in the acquired intangibles list.[209]

Example. Corporation X pays corporation Y, an insurance company, an amount as premiums for a 20–year annuity to fund deferred compensation payments due to be made over that period to a group of X's executives. The amounts paid Y constitute amounts paid to another party to create or originate with that party an annuity contract and must be capitalized. *Amortization*: Such amounts would be recovered as the annuity amounts are paid.[210] The result would be the same if X had paid for a life insurance contract on the life of an executive employee as part of a split-dollar arrangement, except that there would be no deduction or amortization of the premiums.[211]

e. Non-functional currency. Non-functional currency.[212]

Example. The Final Regulations do not provide an example in which a taxpayer pays an amount to another party to "create" a non-functional currency. However, the addition in the Final Regulations of a new created intangible category, "an agreement providing either party the right to use, possess or sell a financial interest" described in the created intangibles list,[213] suggests the example of a contract (a created intangible) to purchase a non-functional currency.

2. Prepaid expenses. A taxpayer is required by the Final Regulations to capitalize prepaid expenses.[214] The Prop. Reg. Preamble noted that existing law

208 *See* Reg. § 1.263(a)–4(d)(2)(vi), *Example 6*.
209 Reg. § 1.263(a)–4(d)(2)(i)(D).
210 I.R.C. § 72(a).
211 I.R.C. § 264(a)(1).
212 Reg. § 1.263(a)–4(d)(2)(i)(E).
213 Reg. § 1.263(a)-4(d)(2)(i)(F).
214 Reg. § 1.263(a)–4(d)(3)(i).

requires the capitalization of prepaid expenses.[215] The Prop. Reg. Preamble further noted that the Proposed Regulations modified slightly the rule contained in the ANPRM, which proposed capitalization of "amounts prepaid for goods, services or other benefits (such as insurance) to be received in the future." The reference to goods (and services) was removed from the Proposed Regulations because the reference to "goods" in the ANPRM caused some to question whether the rule is intended to apply to the acquisition of tangible property, which it is not. The Prop. Reg. Preamble stated that "the rule proposes capitalization of prepaid expenses on the ground that the prepayment creates an intangible asset in the form of a right; specifically, the right to receive goods, services or other benefits in the future."[216] The Prop. Reg. Preamble also confirmed that prepaid expenses have readily ascertainable useful lives that can be amortized under Reg. § 1.167(a)–3(a) over the period covered by the prepayment.[217] The Preamble notes that the Final Regulations retain the requirement in the Proposed Regulations but that the reference to "benefits to be received in the future" was deleted to avoid any implication of a "significant future benefits" test.[218]

Example. N, an accrual basis taxpayer, pays an amount to an insurance company as a single premium in payment for a property insurance policy with a three–year term. The amount paid by N is a prepaid expense and must be capitalized.[219] *Amortization*: The capitalized cost is amortizable ratably over the three-year policy term.[220]

Example. The facts are the same as in the preceding example except that the policy has only a one-year term that begins on February 1, 2004 and the payment is made on December 1, 2003. The payment is a prepaid expense and must be capitalized

---

215 Citing to *Commissioner v. Boylston Market Ass'n*, 131 F.2d 966 (1st Cir. 1942). Preamble, at 67 Fed. Reg. 77703.

216 *Id.*

217 Prop. Reg. Preamble, 67 Fed Reg. at 77709.

218 Preamble, at 69 Fed. Reg. 438. The Prop. Reg. Preamble had clarified that the reference in the rule to "benefits to be received in the future" was not intended to imply a form of "significant future benefit" test applicable to any expenditure that can be expected to result in some future benefit; rather, the rule was intended merely to require capitalization of prepaid expenses. Prop. Reg. Preamble, at 67 Fed. Reg. 77709.

219 *See* Reg. § 1.263(a)–4(d)(3)(ii), *Example 1*.

220 Reg. § 1.167(a)–3(a).

because the right or benefit attributable to the premium payment extends beyond the end of the taxable year in which the payment is made.[221] If, however, the policy term begins on December 15, 2003, the 12–month rule applies because the right or benefit attributable to the premium payment neither extends more than 12 months beyond December 15, 2003 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the year in which the payment is made, so the premium is not required to be capitalized.[222] Alternatively, if the taxpayer elects to capitalize this category of prepaid expense, the premium must be capitalized.[223]

Example. X, a cash method taxpayer, enters into a 24–month real estate lease, as lessee, for which X prepays an amount equal to the entire rent for the two–year term. The amount paid by X is a prepaid expense and must be capitalized.[224] *Amortization*: Amortization is straight-line over the two-year lease term.[225]

Example. The facts are the same as in the preceding example except that the lease term is nine months, commencing June 1, 2004, and the entire rent is prepaid on May 1, 2004. Because the taxpayer is a cash-basis taxpayer, the prepaid rent is not capitalizable under the 12–month rule.[226] However, if the taxpayer is an accrual basis taxpayer, the 12–month rule will *not* result in a deduction for the payment when made because, under the economic performance rules of Section 461, economic performance for payment for the use of property occurs ratably over the period the taxpayer is entitled to use the property. Because economic performance does not occur fully until 2005, the prepaid rent is not taken into account in 2004, and the 12–month rule does not apply to the prepayment, so that capitalization is required.[227]

---

221 *See* Reg. § 1.263(a)–4(f)(8), *Example 1*.
222 *See* Reg. § 1.263(a)–4(f)(8), *Examples 2, 10*.
223 *Id., Example 2*. *See* Reg. § 1.263(a)-4(f)(7).
224 *See* Reg. § 1.263(a)–4(d)(3)(ii), *Example 2*.
225 Reg. § 1.167(a)–3(a).
226 *See* Reg. § 1.263(a)–4(f)(8), *Example 6*.
227 Reg. § 1.461–4(d)(3); *see* Reg. 1.263(a)–4(f)(8), *Example 10* (assumes the recurring item exception of Reg. § 1.461–5 does not apply and that the lease is not a section 467 rental agreement under I.R.C. § 467(d)).

3. Certain memberships and privileges. A taxpayer is required by the Final Regulations to capitalize amounts paid to an organization to obtain, renew, renegotiate or upgrade a membership or privilege from that organization, but the requirement does not extend to an amount paid to obtain, renew, renegotiate or upgrade certification of the taxpayer's products, services or business processes.[228]

Example. A physician's payment to a hospital to obtain staff privileges at the hospital must be capitalized.[229] *Amortization*: If the right or benefit has an indefinite duration, the 15–year safe harbor amortization period applies.[230] If the right or benefit has a definite (ascertainable) duration, the capitalized cost is amortized over that period.[231]

Example. The amount paid by a business as an initiation fee to obtain membership in a trade association must be capitalized.[232] *Amortization*: If the right or benefit has an indefinite duration, the 15–year safe harbor amortization period applies.[233] If the right or benefit has a definite (ascertainable) duration, the capitalized cost is amortized over that period.[234] The result assumes that the deduction is not denied by other provisions of the Code.[235]

Example. The amount paid by an automobile manufacturer to a national quality ratings association to conduct a study and provide a rating of the quality and safety of a line of automobiles is not required to be capitalized.[236]

---

228 Reg. § 1.263(a)–4(d)(4)(i).
229 *See* Reg. § 1.263(a)–4(d)(4)(ii), *Example 1*.
230 Reg. § 1.167(a)–3(b); *see* Preamble, at 67 Fed. Reg. 77709.
231 Reg. § 1.167(a)–3(a).
232 *See* Reg. § 1.263(a)–4(d)(4)(ii), *Example 2*.
233 Reg. § 1.167(a)–3(a).
234 *Id.*
235 The corresponding example in the Proposed Regulations involved an initiation fee to a social club. The Preamble explains that the change was made because the example unintentionally implied that such an amount was required to be capitalized without addressing the implications of I.R.C. § 274(a)(3). Preamble, at 69 Fed. Reg. 438. *See* I.R.C. § 274(a)(3) (disallowing deduction of amounts paid for membership in social clubs).
236 *See* Reg. § 1.263(a)–4(d)(4)(ii), *Example 3*.

Example. The amount paid by a manufacturer to an independent registrar to obtain a certification that the manufacturer's quality management system conforms to a series of international standards known as ISO 9000 is not required to be capitalized.[237]

4. Certain rights obtained from a governmental agency. The Final Regulations require capitalization of amounts paid to a governmental agency to obtain, renew, renegotiate or upgrade its rights under a "trademark, trade name, copyright, license, permit, franchise or other similar right granted by that governmental agency."[238] Patents are not included in this list, although patents would certainly qualify as an "other similar right." The Prop. Reg. Preamble explained that the rule does not affect the treatment of expenditures under other provisions of the Code. "Accordingly, an amount paid to a government agency to obtain a patent from the agency is not required to be capitalized under this section if the amount is deductible under section 174."[239] The Preamble further confirmed the point, stating that "an amount paid to a government agency to obtain a patent … is not required to be capitalized under the final regulations if the amount is deductible under section 174."[240]

The Prop. Reg. Preamble also pointed out that this capitalization rule, in general, is directed at the "initial fee paid to a government agency" and that, under the 12–month rule, taxpayers are not required to capitalize annual renewal fees paid to the government agency.[241] The Preamble clarifies, however, that capitalization is required if a taxpayer renegotiates or upgrades its rights. "For example, a holder of a business license that pays an amount to upgrade its license, enabling it to sell additional types of products or services, must capitalize that amount.[242]

Example. The amount paid by a business to a state to obtain a business license (whether or not the license has a fixed or an indefinite term) must be capitalized. Under the 12–month rule, however, any *annual* renewal or other "fee is not

---

237 *See* Reg. § 1.263(a)–4(d)(4)(ii), *Example 4*.
238 Prop. Reg. § 1.263(a)–4(d)(5)(i).
239 Prop. Reg. Preamble, at 67 Fed. Reg. 77703.
240 Preamble, at 69 Fed. Reg. 438.
241 Prop. Reg. Preamble, at 67 Fed. Reg. 77703
242 Preamble, at 69 Fed. Reg. 438.

capitalizable."[243] *Amortization*: The license is a Section 197 intangible, and the capitalized cost is amortized ratably over 15 years.[244]

Example. The amount paid by an individual to a state agency to obtain a license to practice law (or any other profession) in that state must be capitalized, regardless of whether the license is for a fixed or indefinite term and regardless of whether the condition for the license is adherence to the requirements governing the practice of the profession in that state.[245] *Amortization*: The license is a Section 197 intangible, and the capitalized cost is amortized ratably over 15 years.[246]

5. Certain contract rights. The Final Regulations (as did the Proposed Regulations) provide that amounts paid to another party to create, originate, enter into, renew or renegotiate with that party an agreement that produces rights or benefits for the taxpayer (and amounts paid to facilitate the creation, origination, enhancement, renewal or renegotiation of such an agreement) do not create, (or facilitate the creation of) a "separate and distinct" intangible asset that must be capitalized.[247] The Final Regulations do, however, identify five specific circumstances where such payments must be capitalized. A taxpayer must, in general, capitalize amounts paid to another party to *create, originate, enter into, renew or renegotiate* with that party: (A) an agreement providing the taxpayer the right to use tangible or intangible property or the right to be compensated for the use of such property; (B) an agreement providing the taxpayer the right to provide or to receive services (or the right to be compensated for such services regardless of whether the taxpayer provides such services); (C) a covenant not to compete

---

243 *See* Reg. § 1.263(a)–4(d)(5)(ii), *Example 1*; Reg. § 1.263–4(f)(8), *Example 5*(i), (ii).

244 Reg. § 1.197-2(b)(8).

245 *See* Reg. § 1.263(a)–4(d)(5)(ii), *Example 2*.

246 Reg. § 1.197-2(b)(8). In the absence of I.R.C. § 197, no amortization would be allowed for an indefinite license to enter or practice a professional business. *See, e.g., Kennedy v. Commissioner*, 32 T.C.M. (CCH) 52, 55 (1973) (license to conduct profession); *Webb v. Commissioner*, 55 T.C. 743, 746 (1973) (real estate broker); *Sharon v. Commissioner*, 66 T.C. 515, 526 (1976), *aff'd per curiam*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979) (state bar admission); *Ryman v. Commissioner*, 51 T.C. 799, 803 (1969) (state bar admission); *Adamson v. Commissioner*, 32 T.C.M. (CCH) 484, 487 (1973) (state bar admission in second state). These capitalized professional licensing costs appear to be amortizable under the 15-year period provided by § 197 (although the example in the Final Regulations does not specifically so state) and do not appear to be disallowed under section 262(a) as "personal expenses." *See, e.g., Ryman, supra* at 803-805 (state bar fee must be capitalized; reception costs upon bar admission are nondeductible personal expenditures).

or an agreement having substantially the same effect as a covenant not to compete (under an exception similar to that in Reg. § 1.197–2(b)(9), this category does not cover an amount paid under an agreement for services to the extent the amount paid represents reasonable compensation for those services); (D) an agreement not to acquire additional ownership interests in the taxpayer (*i.e.*, a "standstill" agreement); or (E) an agreement providing the taxpayer (as the covered party) with an annuity, an endowment or insurance coverage.[248]

The Final Regulations add three new rules "to address public concerns that capitalization is not appropriate if the taxpayer has only a hope and expectation that a customer or supplier will begin or continue a business relationship with the taxpayer.[249] First, the Final Regulations provide that any such payment by the taxpayer to another party is not required to be capitalized if it is made with the mere hope or expectation of developing or maintaining a business relationship with that party unless the payment is "contingent on the origination, renewal or renegotiation of an agreement with that party."[250] Second, the Final Regulation provide that an agreement does not provide a "right" to provide services if the agreement merely provides that the taxpayer will stand ready to provide services if requested but places no obligation on another party to request or pay for the taxpayer's services.[251] Third, the Final Regulations provide that an agreement that may be terminated at will by the other party (or parties) prior to the expiration of the 12-month rule period is not an agreement in respect of which a payment must be capitalized unless the other party is economically compelled not to terminate the agreement prior to the expiration of the 12–month rule period.[252]

The Final Regulations also define the term "renegotiate" for these purposes. A taxpayer is treated as renegotiating an agreement if the terms of the agreement are modified or if the taxpayer enters into a new agreement with the same party (or substantially the same parties) to a terminated agreement, the taxpayer could not

---

247 Reg. § 1.263-4(b)(3)(ii); Prop. Reg. § 1.263(a)–4(b)(3)(ii).

248 Reg. § 1.263(a)-4(d)(6)(i)(A)-(E). The Proposed Regulations did not contain the last two categories. *See* Prop. Reg. § 1.263(a)–4(d)(6)(i)(A), (B), (C).

249 Preamble, at 69 Fed. Reg. 438.

250 Reg. § 1.263(e)-4(6)(ii).

251 Reg. § 1.263(a)-4(6)(iv).

cancel the terminated agreement without the other party's agreement and the other party would not have agreed to the cancellation unless the taxpayer entered into the new agreement.[253]

There is a *de minimis* exception to the capitalization requirement for amounts paid for such purposes if the aggregate amount paid to a party (or parties) with respect to an agreement does not exceed $5,000; if that amount is exceeded, then all amounts paid to the other party (or parties) with respect to that agreement must be capitalized.[254] Amounts paid in the form of property are valued at fair market value at the time of payment for this purpose. A taxpayer that reasonably expects to create, originate, enter into, renew or renegotiate at least 25 similar agreements during the taxable year can use a pooling method to determine the amount paid in respect of a particular agreement where the amount deemed paid in respect of each agreement in the pool is the arithmetical average paid with respect to all agreements in the pool.[255]

The Prop. Reg. Preamble stated that this rule and the financial interests rule (described above) are the "exclusive capitalization provisions for created contracts." "In other words, amounts paid to enter into an agreement not identified in these rules are not required to be capitalized under the general principal of capitalization on the theory that the agreement is a separate and distinct asset."[256]

Although a payment by a lessor to a lessee to induce the lessee to enter into a lease is capitalizable, the Final Regulations provide that capitalization is not required for any amount paid by a lessor to a lessee as a construction allowance to the extent the lessee expends the amount for the tangible property that is owned by the lessor

---

252 *Id.*

253 Reg. § 1.263(a)-4(6)(iii). *See* Preamble, at 69 Fed. Reg. 438, citing *U.S. Bancorp v. Commissioner,* 111 T.C. 231 (1998), in support of this position.

254 Reg. § 1.263(a)–4(d)(6)(v).

255 *Id*. *See* Reg. § 1.263(a)–4(h) (providing special rules applicable to pooling).

256 Prop. Reg. Preamble, at 67 Fed. Reg. 77704. The Final Regulations do not include a provision in the Proposed Regulations to the effect that capitalization is not required for amounts paid to another party to induce that party to enter into, renew or renegotiate an agreement providing the taxpayer the right to provide or to acquire services, or to be compensated therefore, if the amount is allocable to services *required* to be provided or acquired by the taxpayer prior to the end of the taxable year in which the amount is paid. Prop. Reg. § 1.263(a)-4(d)(6)(iii)(A).

for federal income tax purposes.[257] From the lessor's perspective, a construction allowance can have the same effect as a reduction in rent and so should be deductible. Note that, under Section 110, a lessee of retail space in a "short-term lease" that receives a construction allowance to improve the lessor's "long-term real property" used in the lessee's trade or business is not taxable on the construction allowance.[258] Moreover, under Section 109, a lessor does not recognize gross income from the value of lessee improvements on the lessor's real property upon the termination of the lease term (unless the lessee improvements are, in fact, a "liquidation in kind of lease rentals").[259]

Example. A prospective lessee pays the owner of commercial real estate an amount in exchange for the owner entering into a ten-year lease. If the amount paid exceeds $5,000, the entire amount must be capitalized as an amount paid to another party to enter into an agreement providing the taxpayer the right to use tangible property.[260] *Amortization*: An interest under a lease is not a Section 197 intangible; the amount paid is deductible over the lease term (including, in some cases, renewal periods).[261]

Example. A business that leases the equipment it uses pays the lessor an amount to extend the lease term by a number of years. If the amount paid exceeds $5,000, the entire amount must be capitalized as an amount paid to another party to renegotiate an agreement providing the taxpayer the right to use tangible property.[262] *Amortization*: An interest under a lease is not a Section 197 intangible; the amount paid is deductible over the lease term (including, in some cases, renewal periods).[263]

Example. A business pays an individual to enter into a covenant not to compete for a three-year period. If the amount paid exceeds $5,000, the entire amount must be capitalized as an amount paid to another party to enter into a covenant not to compete.[264] *Amortization*: A covenant not to compete not acquired in connection with the direct or indirect acquisition of a trade or business, or a substantial portion thereof, is

---

[257] Reg. § 1.263(a)–4(d)(6)(vi).
[258] Reg. § 1.110–1(a).
[259] Reg. § 1.109–1(a).
[260] *See*. Reg. § 1.263(a)–4(d)(6)(vii), *Example 1*.
[261] Reg. § 1.197–2(c)(8)(ii); Reg. § 1.162–11(a); I.R.C. § 178.
[262] *See* Reg. § 1.263(a)–4(d)(6)(vii), *Example 2*.
[263] Reg. § 1.197–2(c)(8)(ii); Reg. § 1.162–11(a); I.R.C. § 178.

not a Section 197 asset; the capitalized cost is therefore amortizable over the three–year covenant term.[265]

Example. A wireless telecommunications business provides a free cell phone to each new customer who enters into a three-year contract. Because the $300 fair market value of each cell phone is less than $5,000, the amount paid each customer as an inducement to enter into an agreement providing the taxpayer the right to provide services is not required to be capitalized.[266]

6. Certain contract terminations. The Final Regulations provide (as did the Proposed Regulations) that amounts paid to another party to terminate (or facilitate the termination of) an agreement with that party do not create a "separate and distinct" intangible asset.[267] However, the Final Regulations do (as did the Proposed Regulations) require the capitalization of amounts paid to another party to terminate agreements falling within three categories: (A) a lease of real or tangible personal property between the taxpayer (as lessor) and that party (as lessee); (B) an agreement that grants that party the *exclusive* right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business (other than certain "ownership" and "financial interests");[268] or (C) an agreement that prohibits the taxpayer from acquiring property or services from a competitor of that party.[269] The Prop. Reg. Preamble explained that the policy behind requiring capitalization of these types of termination payments is that in those situations the taxpayer acquires some valuable right it did not possess immediately prior to the termination, citing existing law to the same effect.[270] Consistently, the Prop. Reg. Preamble notes that the rule does not require capitalization of termination payments where the taxpayer, as a result of the termination, does not reacquire a valuable right.[271]

---

264 *See* Reg. § 1.263(a)–4(d)(6)(vii), *Example 6*.
265 Reg. § 1.197–2(b)(9); Reg. § 1.167(a)–3(a).
266 *See* Reg. § 1.263(a)–4(d)(6)(vii), *Example 10*.
267 Reg. § 1.263(a)-4(b)(3)(ii). *See* Prop. Reg. § 1.263(a)–4(b)(3)(ii).
268 Consisting of the ownership interests and the financial interests described in Reg. § 1.263(a)-4(c)(1)(i)-(iv), (d)(2).
269 Reg. § 1.263(a)-4(d)(7)(i)(A), (B), (C). *See* Prop. Reg. § 1.263(a)–4(d)(7)(i)(A), (B), (C).
270 Citing to *Peerless Weighing & Vending Machine Corp. v. Commissioner*, 52 T.C. 850 (1969); *Rodeway Inns of America v. Commissioner*, 63 T.C. 414 (1974). Prop. Reg. Preamble, at 67 Fed. Reg. 77704.
271 Prop. Reg. Preamble, at 67 Fed. Reg. 77704.

Thus, a taxpayer's payment to terminate a supply contract with a supplier, or to terminate, as lessee, a lease agreement with a lessor, is not required to be capitalized (while, as stated, a lessor's payment to a lessee to terminate a lease is covered by the rule), citing existing law to the same effect.[272]

The Final Regulations add a provision to the effect that the contract termination provisions of Reg. § 1.263(a)-4(d)(6) do not apply to the "break-up fee" transactions dealt with separately in Reg. § 1.263(a)-5(c)(8).[273]

Example. A lessor pays its lessee an amount to terminate the lease when the lease has 5 more years to run. The payment must be capitalized because it is a payment by a landlord to a lessee to terminate a lease. *Amortization*: The capitalized cost is recovered ratably over the five-year remaining term of the contract.[274] If, however, the remaining lease term at the time of the payment is only nine months, the payment creates a benefit of such duration only and the 12–month rule applies so that capitalization is not required.[275]

Example. A business owning design patents and related trademarks pays an amount to a manufacturer, to which it has previously granted an *exclusive* license to manufacture goods using the taxpayer's design and trademarks, to terminate the exclusive license agreement. The amount must be capitalized because it is a payment to terminate an exclusive license to use the taxpayer's property. *Amortization*: The capitalized cost is recovered ratably over the five–year remaining term of the contract.[276] The result would be the same if the payment had been made to a *sole* distributor to terminate the distribution agreement because it is a payment to terminate an *exclusive* right to distribute the taxpayer's property.[277]

---

[272] *Id.,* citing to *Stuart v. Commissioner*, 195 F.2d 176 (9th Cir. 1952, *aff'g* 9 T.C.M. (CCH) 585 (1950); *Olympia Harbor Lumber Co. v. Commissioner*, 30 B.T.A. 114 (1934), *aff'd*, 79 F.2d 394 (9th Cir. 1935); *Denholm & McKay Co. v. Commissioner*, 2 B.T.A. 444 (1925), Rev. Rul. 69-511, 1969-2 C.B. 24.

[273] Reg. § 1.263(a)-4(d) (7)(ii).

[274] Reg. § 1.263(a)–4(f)(2); Reg. § 1.167(a)–3(a); Prop. Reg. Preamble, at 67 Fed. Reg. 77709.

[275] *See* Reg. § 1.263(a)–4(f)(2), (8), *Examples 7, 8*.

[276] Reg. § 1.167(a)–3; Prop. Reg. Preamble, at 67 Fed. Reg. 77709.

[277] *See* Reg. § 1.263(a)–4(d)(7)(iii), *Examples 1, 2*.

Example. The amount a taxpayer pays another party to terminate a covenant not to compete having a remaining term of more than one year must be capitalized.[278] *Amortization*: The capitalized cost is recovered ratably over the remaining term of the contract.[279]

Example. The amount paid by a taxpayer entity to terminate a merger agreement with another entity is not required to be capitalized because such "break-up fees" are governed by Reg. § 1.263(a)-5, discussed below. The Final Regulations note that such a break-up fee does not, in any event, create a "separate and distinct intangible asset."[280]

7. Certain benefits arising from the provision, production or improvement of real property. The Final Regulations require the capitalization of amounts paid for real property if the taxpayer transfers ownership of the real property to another person (except to the extent the real property is sold for fair market value) but only if the real property can be expected to produce significant economic benefits for the taxpayer after the transfer.[281] "Real property" for this purpose includes property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as roads, bridges, tunnels, pavements, wharves and docks, breakwaters and sea walls, elevators, power generation and transmission facilities and pollution control facilities.[282] The Prop. Reg. Preamble explained that this capitalization rule is limited to *real property* and not to all tangible property as originally contemplated by the ANPRM.[283] Although some courts have required capitalization on the ground that an intangible asset is created where the taxpayer provides tangible personal property to another,[284] the Prop. Reg. Preamble stated that the IRS and Treasury are reluctant to

---

278 *See* Reg. § 1.263(a)–4(d)(7)(iii), *Example 3*.
279 Reg. 1.263(a)–4(f)(2); Reg. § 1.167(a)–3(a); Prop. Reg. Preamble, at 67 Fed. Reg. 77709.
280 *See* Reg. § 1.263(a)–4(d)(7)(iii), *Example 4*.
281 Reg. § 1.263(a)–4(d)(8)(i).
282 Reg. § 1.263(a)–4(d)(8)(iii).
283 Prop. Reg. Preamble, at 67 Fed. Reg. 77704 – 77705.
284 The Prop. Reg. Preamble cites to *Alabama Coca-Cola Bottling Co. v. Commissioner*, T.C. Memo. 1969-123 (capitalization required for costs incurred by a wholesaler to provide signs, scoreboards and clocks bearing its product logo to retail outlets because the expenditures created valuable benefits that would benefit the taxpayer beyond the taxable year). *Id.*

expand the rule to cases involving tangible personal property because to do so "would require the capitalization of many expenditures that are properly deductible under current law, such as advertising or business promotion costs."[285]

The Prop. Reg. Preamble explained that the purpose of the rule, to require capitalization where a taxpayer's providing real property to, or improving real property of, another is done so with the expectation that the property will provide significant future benefits to the taxpayer, is consistent with existing case law.[286] The capitalized costs under this rule are recovered, however, under the special 25–year straight-line safe harbor amortization rule. The Prop. Reg. Preamble explained that it was decided not to allow capitalized intangible costs be recovered over the recovery period prescribed for the real property as if the taxpayer had owned and used the property in its trade or business because that approach would raise difficult questions regarding the appropriate class life and would not address the treatment for property for which no recovery period is prescribed under Section 168.[287]

These capitalization rules do *not* apply if the taxpayer transfers real property or pays an amount to produce or improve real property in exchange for services, the purchase or use of property or the creation of another intangible that is subject to the capitalization rules in respect of payments to create or enhance an intangible.[288] The exceptions to the rule apply only to the extent the taxpayer receives fair market value consideration for the real property.[289]

---

[285] Prop. Reg. Preamble, at 67 Fed. Reg. 77704 - 77705.

[286] Citing to *D. Loveman & Sons Export Corp. v. Commissioner*, 34 T.C. 776 (1960), *aff'd*, 296 F.2d 732 (6th Cir. 1961) (expenditures incurred by the taxpayer to pave a public road benefited the taxpayer's business and were appropriately capitalized); *Chicago & N.W. Railway Co. v. Commissioner*, 39 B.T.A. 661 (1939) (conveyance of land by a railroad to a city for highway purposes, the effect of which is of lasting benefit by way of flood protection, access to city streets, and reduced cost of crossing protection is a capital expenditure); *Kauai Terminal Ltd. v. Commissioner*, 36 B.T.A. 893 (1937) (expenditures incurred by the taxpayer to construct a publicly owned breakwater for the purpose of improving the taxpayer's freight lighterage operation are capital expenditures); Rev. Rul. 69–229, 1969-111 C.B. 86 (expenditures incurred by a railroad company for construction of a state-owned highway bridge over its tracks create a long-term business benefit for the taxpayer and are therefore capital expenditures); Rev. Rul. 66–71, 1966–1 C.B. 44 (expenditures incurred by the taxpayer for dredging to deepen the portion of a harbor alongside the taxpayer's pier leading to a navigable channel are capital expenditures). *Id.*

[287] Prop. Reg. Preamble, at 67 Fed. Reg. 77704 – 77705.

[288] Reg. § 1.263(a)–4(d)(8)(ii)(A), (B), (C), (D).

[289] *Id. See* Preamble, at 69 Fed. Reg. 438-439.

Example. A taxpayer's payment to a city to defray part of the cost of building a publicly owned bridge capable of accommodating the taxpayer's trucks that transfer materials across a river from one of the taxpayer's facilities to another is capitalizable (and recoverable under the 25–year safe harbor) because it is an amount paid to produce real property that can reasonably be expected to produce significant economic benefits for the taxpayer.[290]

These capitalization rules do not apply to amounts paid for "dedicated improvements" (real property or improvements to real property constructed by the taxpayer where the real property or improvements benefit new development or expansion of existing development, are immediately transferred to a state or local government for dedication to the general public use, and are maintained by the state or local government.[291]

Example. A taxpayer developer's payment to a subcontractor to construct ingress and egress roads to a residential housing development of the taxpayer where the roads will be transferred to the city for dedication to general public use and will be maintained by the city is a payment for a "dedicated improvement" that is not required to be capitalized under the Proposed Regulations. Nevertheless, the payment is subject to Section 263A, which requires that such costs be capitalized to the basis of the developed property.[292]

These capitalization rules do *not* apply to amounts paid to a state or local government as "impact fees" (one-time charges to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development).[293]

Example. A taxpayer developer pays "impact fees" to a city as a condition of receiving entitlements necessary to complete a development project in the city. The

---

290 *See* Reg. § 1.263(a)–4(d)(8)(v), *Example 1*.
291 Reg. § 1.263(a)–4(d)(8)(iv).
292 *See* Reg. § 1.263(a)–4(d)(8)(v), *Example 3*.
293 Reg. § 1.263(a)–4(d)(8)(iv).

impact fees are not capitalizable but are subject to capitalization to the basis of the real property under Revenue Ruling 2002–9.[294]

8. Defense or perfection of title to intangible property. The Final Regulations require taxpayers to capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer's title.[295] The Prop. Reg. Preamble pointed out that this treatment is consistent with the existing regulations under Section 263(a), at Reg. § 1.263(a)–2(c).[296]

The Prop. Reg. Preamble also explained that the rule is not intended to require capitalization of amounts paid to protect the taxpayer's intangible property against infringement and to recover profits and damages as a result of an infringement because, under existing law, such expenses are currently deductible.[297] The Prop. Reg. Preamble pointed out, however, that whether an amount is paid to defend or perfect title, on the one hand, or to protect against infringement, on the other, is a "factual matter."[298]

The Final Regulations clarify that the capitalization rules relating to defense or perfection of title to intangible property are not applicable to "break-up fees" in a transaction termination governed by Reg. § 1.263(a)-5(a).[299]

Example. An amount paid by a taxpayer to another to settle a lawsuit brought against the taxpayer by that party challenging the taxpayer's title to an exclusive patent on a particular technology owned by the taxpayer is capitalizable as a payment to another party to defend or perfect title to intangible property that is challenged by that

294 Rev. Rul. 2002-9, 2002–10 I.R.B. 614. *See* Prop. Reg. Preamble, at 67 Fed. Reg. 77704 – 77705.
295 Reg. § 1.263(a)–4(d)(9)(i).
296 Prop. Reg. Preamble, at 67 Fed. Reg. 77705.
297 Citing to *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954) (expenditures made by a licensor of patents to protect against infringement and to recover profits and damages were made to protect, conserve, and maintain business profits, and not to defend or perfect title to property). *Id.*
298 *Id.*
299 Reg. § 1.263(a)-4(d)(9)(ii).

party.[300] The capitalized cost is amortizable ratably over the remaining life of the patent or under the income forecast method.[301]

V. The Final Regulations – "Transaction Costs" Under Reg. § 1.263(a)-4 (Costs of Facilitating the Acquisition or Creation of an Intangible).

A. Transaction Costs – "Facilitate." The Final Regulations require taxpayers to capitalize an amount paid to "facilitate" the acquisition or creation of an intangible.[302] The "acquisition or creation of an intangible" is referred to as the "transaction" in the Final Regulations, and "transaction" is further defined as "all of the factual elements comprising an acquisition or creation of an intangible," including "a series of steps carried out as part of a single plan."[303] An amount is paid to "facilitate" the transaction "if the amount is paid in the process of investigating or otherwise pursuing the transaction."[304]

The Proposed Regulations used only the phrase "in the process of pursuing" in defining "facilitate." The Final Regulations add the term "investigating." The Preamble explains that the government believes "that it is inappropriate to distinguish amounts paid to investigate the acquisition or creation of an intangible from other amounts paid in the process of acquiring or creating an intangible."[305] The Final Regulations provide that whether an amount is paid in the process of investigating or otherwise pursuing the transaction is a facts and circumstances determination but further clarify that an amount paid to "determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction."[306]

The Final Regulations retract a simplifying position adopted in the Proposed Regulations that provided that the fact that an amount would (or would not) have been

---

300 *See* Reg. § 1.263(a)–4(d)(9)(ii), *Example*.

301 Reg. § 1.167(a)-3(a); Section 167(g); Prop. Reg. §1.167(n)-1, *et seq.* A patent not acquired in connection with the purchase of a trade or business is not a section 197 asset. Reg. § 1.197–2(c)(7).

302 Reg. § 1.263(a)-4(b)(v).

303 Reg. § 1.263(a)-4(e)(1).

304 Reg. § 1.263(a)-4(e)(1)(i). It is not relevant to whether a payment to *facilitate* a transaction to create an intangible is capitalized that the payment to *create* that intangible has or has not been made. Reg. §1.263(a)-4(e)(2).

305 Preamble, at 69 Fed. Reg. 439.

paid "but for" the transaction is "not relevant."[307] The Prop. Reg. Preamble explained that the "facilitate standard" is intended to be narrower in scope than a "but-for standard." "Thus, some transaction costs that arguably are capital under a but-for standard, such as costs to downsize a workforce after a corporate merger (including severance payments) or costs to integrate the operations of a merged business, are not required to be capitalized under a facilitate standard. While such costs may not have been incurred but for the merger, the costs do not facilitate the merger itself."[308] Backing off, the government in the Final Regulations rejects the "not relevant" position of the Proposed Regulations and adopts the position that whether an amount would or would not have been paid "but for" the transaction is a relevant factor, but not the only factor, to be considered.[309] Specifically, the Final Regulations state that it is relevant but "not determinative."[310]

To address the concern that otherwise deductible costs incurred to sustain or expand a taxpayer's business might be capitalizable under the "facilitate" standard, the Final Regulations add a rule providing that an amount is not to be treated as paid in the process of investigating or otherwise pursuing the creation of a *contract* right if the amount "relates to activities performed before the *earlier* of the date the taxpayer begins preparing its bid for the agreement or the date the taxpayer begins discussing or negotiating the agreement with another party to the agreement."[311]

The Proposed Regulations provided a rule under which amounts paid to terminate (or facilitate the termination of) an existing agreement are treated as facilitating *another* transaction that is *expressly conditioned* on the termination of the agreement.[312] The Final Regulations eliminate that rule and, in effect, reverse position inasmuch as they provide, unconditionally, that any amount paid to terminate (or facilitate the termination of) an existing agreement does *not* facilitate the acquisition or creation of another

---

306 Reg. § 1.263(a)-4(e)(1)(i).
307 Prop. Reg. § 1.263(a)-4(e)(1)(i).
308 Prop. Reg. Preamble, at 67 Fed. Reg. 77706.
309 Preamble, at 69 Fed. Reg. 439.
310 Reg. § 1.263(a)-4(e)(1)(i).
311 Reg. § 1.263(a)-4(e)(1)(iii); Preamble, at 69 Fed. Reg. 439.
312 *See* Prop. Reg. § 1.263(a)-4(e)(1)(ii).

agreement. . . ."[313] The Preamble explains that the government was concerned that well-advised taxpayers could have easily avoided the rule (while for unwary others it could be a trap) and that a "mutually exclusive" rule,[314] instead of the abandoned "expressly conditioned" rule, was not adopted because it would have been administratively difficult to apply in the context of ordinary business transactions, as well as because of a concern that it could have been interpreted as "requiring capitalization of contract termination costs that historically have been deductible (for example, an amount paid to terminate a burdensome supply contract if the taxpayer enters into a new supply contract (for which capitalization is required under the regulations) with another party if the taxpayer could not contract with both parties)." [315]

The examples of capitalizable "transaction costs" that are provided in the Final Regulations refer to legal services in negotiating and drafting an agreement that would be a created intangible under the Final Regulations, legal services and related accounting and appraisal fees in a state court lawsuit to establish the value of stock, and travel expenses to the taxpayer's customer incurred in discussing and negotiating a contract with the customer after the taxpayer has begun to prepare the bid, as well as travel expenses to the customer to further develop the business relationship by introducing new employees, updating the customer on current developments and taking the customer's executives to dinner.[316]

B. Transaction Costs Under Reg. § 1263(a)-4 – Simplifying Conventions.

1. Employee Compensation and Overhead. The Prop. Reg. Preamble observed that much of the recent debate under Section 263(a) has focused on the "extent to which capitalization is required for employee compensation and overhead costs that are related to the acquisition, creation or enhancement of an asset."[317] Thus, in some cases, capitalization has been required where the costs are clearly allocable to a particular

---

313 Reg. § 1.263(a)-4(e)(1)(ii).

314 Such as the one contained in Reg. § 1.263(a)-5.

315 Preamble, at 69 Fed. Reg. 439.

316 *See* Reg. § 1.263(a)-4(e)(5), *Examples 1, 3 and 4.* There is a special rule in the Final Regulations that an amount paid by an open-end regulated investment company (within the meaning of I.R.C. §851) to "facilitate the redemption of its stock" is not capitalizable as a transaction cost. Reg. §1.263(a)-4(e)(1)(v).

intangible asset.[318] In other cases, current deductions have been allowed for compensation allocable to work performed by corporate officers in negotiating the transaction because the compensation originated from the employment relationship between the taxpayer and its officers and not from the transaction itself.[319] The Prop. Reg. Preamble announced that the Proposed Regulations seek to resolve the controversy and to eliminate the burden on taxpayers of allocating transaction costs among intangibles by providing a "simplifying assumption" that employee compensation and overhead costs do *not* facilitate the acquisition, creation or enhancement of an intangible asset (or facilitate a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital).[320]

The Final Regulations do not alter the simplifying assumption. Under the Final Regulations, *all* employee compensation, whether paid in the form of salary, bonus or commission, will be deductible currently.[321] The Proposed Regulations limited this convention to "employees" as defined in section 3401(c) of the Code (thus excluding from its ambit independent contractors who are service providers, as well as directors, partners and employees of related entities).[322] The Final Regulations expand the meaning of employee compensation for this purpose to include a guaranteed payment to a partner, payment of a corporate director's annual compensation (for attendance at regular meetings of the board and of board committees but not for attendance at special meetings of the board or of board committees), and payment to an independent contractor (including a corporate employer of the individual performing the services) for secretarial, clerical or similar administrative support services. Also, a payment by one member of an affiliated group of corporations filing a consolidated return to another member of the group for services performed by an employee of that member at a time when both members are affiliated is treated as "employee compensation" for this purpose.[323]

---

317 Prop. Reg. Preamble, at 67 Fed. Reg. 77707.

318 *See, e.g.*, *Lychuk v. Commissioner*, 116 T.C. 374 (2001).

319 *See, e.g.*, *PNC Bancorp., Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000); *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000).

320 Prop. Reg. Preamble, at 67 Fed. Reg. 77707.

321 See Reg. § 1.263-4(e)(4)(i), (ii).

322 *See* Prop. Reg. § 1.263(a)-4(e)(3)(i).

323 Reg. § 1.263(a)-4(e)(4)(ii)(B).

2. Overhead. Similarly, under the Final Regulations all expenditures for overhead are permitted to be deducted currently, regardless of the purpose for which they are incurred.[324]

3. *De Minimis* Transaction Costs. *De minimis* costs are treated as not facilitating a transaction and are defined as transaction costs that, in the aggregate for a transaction, do not exceed $5,000.[325] In determining whether the $5,000 threshold is met, employee compensation and overhead are not taken into account.[326] Thus, under the Final Regulations, a taxpayer is not required to capitalize costs of a transaction if the aggregate costs do not exceed $5,000.[327] If the aggregate transaction costs exceed $5,000, no portion is treated as *de minimis*.

Example: In connection with the acquisition of an intangible (other than a financial interest, such as corporate stock), a taxpayer pays a broker's commission of $4,000 and a legal fee of $4,000. The entire $8,000 is required to be capitalized, even though each payment is less than the *de minimis* amount.

In general, the aggregate costs of each separate transaction are taken into account for this purpose, but, where the taxpayer reasonably expects to enter into at least 25 similar transitions during the taxable year, all similar transactions may be pooled so that an average transaction cost may be computed with respect to all transactions included in the pool.[328] Under that pooling method, the amount of transaction costs relating to any particular transaction is equal to the average transaction costs for each of the transactions included in the pool.[329]

---

324 Reg. Reg. § 1.263(a)-4(e)(4)(i). *See also* Reg. § 1.263(a)–4(e)(5), *Example 8* (overhead and compensation costs of a commercial bank's loan acquisition department are currently deductible notwithstanding that the *sole* function of the department is to acquire loans from other financial institutions that are carried as capital assets).

325 Reg. § 1.263(a)-4(e)(4)(iii)(A). The *de minimis* rule does not apply to *commissions* paid to acquire or create certain financial interests and so must always be capitalized in such circumstances. Under the Final Regulations, however, commissions paid to employees are deductible under the employee compensation rule in any event. Reg. § 1.263(a)-4(e)(4)(i).

326 *See* Prop. Reg. § 1.263(a)-4(l), *Example 1(iii), (iv)*.

327 The government reserves the right to increase that amount in future published guidance. Reg. § 1.263(a)-4(e)(iii)(A).

328 Reg. § 1.263(a)-4(e)(4)(iii)(A).

329 Reg. § 1.263(a)–4(e)(4)(iii)(A).

4. Book-Tax Conformity Not Required. The rationale for the general rule permitting deduction of all employee compensation and overhead is simplification. In keeping with that rationale, the Prop. Reg. Preamble, as did the ANPRM, solicited comments as to whether capitalization of employee compensation and overhead should be required for tax purposes if capitalization is required for book purposes under generally accepted accounting principles.[330] Such book-tax conformity had drawn some limited support from commentators who have noted that the rationale for the rule -- simplification -- would not be met if capitalization is required by financial accounting.[331] Others have questioned the relevance and equity of the use of financial accounting in this circumstance.[332]

The government abandoned any requirement of book-tax conformity in the Final Regulations. To the contrary, the Final Regulations allow a taxpayer to elect to capitalize employee compensation, overhead or *de minimis* costs (or any combination).[333] The election is made separately for each transaction.[334] The Preamble explains that "[s]everal commentators noted that taxpayers may capitalize such costs for financial accounting purposes, and it may be difficult to segregate these costs for Federal income tax purposes."[335]

5. Clear Reflection of Income – Regular and Recurring Costs. The Final Regulations do not modify the firm policy expressed in the Proposed Regulations that a "regular and recurring" rule would not be incorporated into the regulatory scheme. The Prop. Reg. Preamble stated that, after reviewing public comments on the issue whether the recurring or nonrecurring nature of a transaction is an appropriate consideration in determining whether an expenditure incurred to facilitate a transaction

---

330 Prop. Reg. Preamble, at 67 Fed. Reg. 77707; ANPRM at ¶ D.2.

331 *See, e.g.,* NEW YORK STATE BAR ASSOCIATION TAX SECTION, *Report on Notice of Proposed Rulemaking on Deduction and Capitalization of Expenditures Relating to Intangibles (Report No. 1031)*, 24, 25 (March 25, 2003)(hereafter, "NYSBA").

332 *See, e.g.,* AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *Comments on Proposed Regulations Providing Guidance Regarding Deduction and Capitalization of Expenditures*, 22–23 (April 21, 2003) (hereafter, "AICPA").

333 Reg. §1.263(a)-4(e)(4)(iv).

334 The election is made on the taxpayer's timely filed return for the year of payment; the election is made by each member of a consolidated group, by a partnership and by an S corporation. *Id.*

335 Preamble, at 69 Fed. Reg. 440.

must be capitalized (or not) under Section 263(a), it was concluded that a regular and recurring rule would be "too vague and unadministrable."[336]

VI. The Final Regulations – "Transaction Costs" Under Reg. § 1.263(a)-5 (Costs of Facilitating the Acquisition of a Trade or Business or a Change in Capital Structure, etc.).

A. Transaction Costs – Business Acquisition and Capital Structure Changes – General Rule.

1. Transactions Covered. The Final Regulations more clearly identify the types of business acquisition or capital structure change transactions for which the related transactional costs must be capitalized than did the Proposed Regulations.[337] Under the Proposed Regulations, capitalizable business acquisition/capital structure change transaction costs were described very generally as amounts "paid to facilitate … the acquisition, creation or enhancement of a capital asset" and amounts "paid to facilitate … a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing or recapitalization."[338] The Final Regulations specifically identify the transactions governed by the business acquisition/capital structure change transaction cost capitalization "general rule," "without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction:"[339]

> (1) An acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition).
>
> (2) An acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer

---

336 Prop. Reg. Preamble, at 67 Fed. Reg. 77708.
337 Preamble, at 69 Fed. Reg. 441.
338 *See* Prop. Reg. §§ 1.263(a)-4(b)(1)(ii), (iii).
339 Reg. § 1.263(a)-5(a).

and the business entity are related within the meaning of Section 267(b) or 707(b).[340]

(3) An acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise).

(4) A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in Section 368 and distributions of stock by the taxpayer as described in Section 355).

(5) A transfer described in Section 351 or Section 721 (whether the taxpayer is the transferor or transferee).

(6) A formation or organization of a disregarded entity.

(7) An acquisition of capital.

(8) A stock issuance.

(9) A borrowing.[341]

(10) Writing an option.[342]

The Preamble explains that the Proposed Regulations applied only to amounts paid to acquire or facilitate the acquisition of intangibles acquired as part of a trade or business and not to amounts paid to acquire or facilitate the acquisition of tangible assets acquired as part of a trade or business. "To avoid the application of one set of rules to intangible assets acquired in the acquisition of a trade or business and a different set of

---

340 This regulation refers to Reg. § 1.263(a)-4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, or to facilitate the acquisition of an ownership interest in a business entity, where the taxpayer and the business entity are not related within the meaning of I.R.C. § 267(b) or 707(b).

341 For this purpose, a borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization. A borrowing also includes debt issued in a debt-for-debt exchange under Reg. § 1.1001-3.

rules to the tangible assets acquired in the acquisition, the final regulations under § 1.263(a)-5 provide a single set of rules for amounts paid to facilitate an acquisition of a trade or business, regardless of whether the transaction is structured as an acquisition of the entity or as an acquisition of assets (including tangible assets) constituting a trade or business."[343]

2. "Facilitate." The scope of the term "facilitate" is the same as for intangible transaction costs under Reg. § 1.263(a)-4(e): an amount "paid in the process of investigating or otherwise pursuing the transaction."[344] The same rules regarding a facts and circumstances determination, the relevancy of a "but-for" test and amounts paid to determine the value or price of a transaction are applicable under Reg. § 1.263(a)-5.[345]

An additional rule is provided to the effect that a capitalizable transaction cost is not the purchase price of the acquired asset, which is separately capitalizable under different rules: the purchase price paid to the target in an asset acquisition in exchange for its assets is not a transaction cost; nor is the price paid by the acquirer to a target's shareholders in exchange for their stock.[346]

3. Special Rules. The Final Regulations provide special rules for the following costs:

a. Borrowing Costs. An amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing).[347] Thus, the transaction costs for the issuance of debt (such as legal fees and investment banking fees) to finance a stock acquisition are not treated as capitalizable costs to facilitate the stock acquisition.[348]

---

342 Reg. § 1.263(a)-5(a)(1)-(10).
343 Preamble, at 69 Fed. Reg. 441.
344 Reg. § 1.263(a)-5(b). *See* Reg. § 1.263(a)-4(e)(1)(i).
345 Reg. § 1.263(a)-5(b)(1). *See* Reg. § 1.263(a)-4(e)(1)(i).
346 Reg. § 1.263(a)-5(b)(1), referring to Reg. §§ 1.263(a)-1, 1.263(a)-2 and 1.263(a)-4 "for rules requiring capitalization of the purchase price paid to acquire property."
347 Reg. § 1.263(a)-5(c)(1).
348 The debt issuance costs are treated separately under Reg. § 1.446-5.

b. Asset Sale Costs. An amount paid to facilitate an asset sale does not facilitate another transaction (other than the sale).[349] For example, amounts paid to facilitate the sale of unwanted assets by a target in preparation for a merger are not treated as capitalizable costs to facilitate the merger.[350] This modifies the rule in the Proposed Regulations, which required capitalization of costs facilitating an asset sale where the sale was both mandatory (required by law, regulatory mandate or court order) and facilitative of another capital transaction.[351] Thus, under the Final Regulations, where a taxpayer, to secure regulatory or court approval for its proposed acquisition of a target, complies with a government mandate or court order to divest itself of a particular trade or business and sells the assets of that trade or business in a taxable sale, the transaction costs of that sale will not be treated as the transaction costs to acquire the target.

c. Mandatory Stock Distributions. The Proposed Regulations did not require the capitalization of the transaction costs of a mandatory (required by law, regulatory mandate or court order) distribution of stock unless the divestiture itself facilitated another capital transaction.[352] The Final Regulations eliminate the exception. Accordingly, under the Final Regulations, the transaction costs of a mandated stock divestiture are not capitalizable even though the mandated divestiture is a condition to the regulatory or court approval of the proposed acquisition of a target corporation.[353] The Final Regulations also provide that a taxpayer is not required (under either Reg. § 1.263(a)-4 or § 1.263(a)-5) to capitalize the organization costs for, or the costs to transfer assets to, an entity organized to receive the taxpayer's properties if the entity is organized solely to receive such properties because of a mandated divestiture and the entity's stock is distributed to the taxpayer's shareholders.[354]

d. Bankruptcy Reorganization Costs. The Final Regulations provide that the costs of instituting and administering a Chapter 11 proceeding are

---

349 Reg. § 1.263(a)-5(c)(2).
350 *Id.*
351 Preamble, at 69 Fed. Reg. 441. *See* Prop. Reg. § 1.263(a)-4(e)(4)(ii)(B).
352 *See* Prop. Reg. § 1.263(a)-4(e)(4)(ii)(A).
353 Reg. § 1.263(a)-5(c)(3).
354 Reg. § 1.263(a)-5(c)(3).

generally required to be capitalized, regardless of the purpose for which the proceeding is instituted, but the costs of operating the business during the proceeding are not so treated.[355]

An amount paid to defend against the commencement of an involuntary bankruptcy proceeding against the taxpayer is not required to be capitalized; nor are the costs incurred in a Chapter 11 proceeding that specifically pertain to resolving the taxpayer's tort liability if those costs would have otherwise have been deductible currently under Section 162 had the bankruptcy not been instituted.[356]

e. Stock Issuance Costs of Open-Ended Mutual Funds. As under Reg. § 1.263(a)-4(e), the transaction costs of an open-ended regulated investment company (within the meaning of Section 851) to issue its stock are not required to be capitalized.[357]

f. Integration Costs. A taxpayer is not required to capitalize the costs of "integrating" the business operations of another with its own, regardless of when the integration activities occur.[358] Thus, the rule precludes the application of the "but-for" test for integration costs. For example, even though such costs would not have been incurred but for an acquisition of another business by the taxpayer, the costs are not required to be capitalized.

g. Registrar/Transfer Agent Fees. An amount paid to a registrar or transfer agent in connection with the transfer of the taxpayer's capital stock is not capitalizable unless the amount is paid in connection with a capital transaction.[359] For example, a transfer agent's fees for maintaining records of the names and addresses of shareholders who trade the taxpayer's shares on a national exchange are not required

---

[355] Reg. § 1.263(a)-5(c)(4). Such operating costs include the types of costs described in Rev. Rul. 77-204. 1977-1 C.B. 40. Preamble, at 69 Fed. Reg. 441.
[356] *Id.*
[357] Reg. § 1.263(a)-5(c)(5).
[358] Reg. § 1.263(a)-5(c)(6).
[359] Reg. § 1.263(a)-5(c)(7).

to be capitalized, but such fees are required to be capitalized if paid for distributing proxy statements seeking shareholder approval of a business acquisition transaction.[360]

h. Costs Associated With Terminated Transactions – Break-Up Fees. The Final Regulations require the capitalization of amounts paid to terminate (or to facilitate the termination of) an agreement to enter into a capital transaction as an amount paid to facilitate a second capital transaction *only* if the transactions are "mutually exclusive" (and the first agreement is terminated to enable the taxpayer to engage in the second transaction).[361] This modifies the rule in the Proposed Regulations, which required capitalization if the subsequent transaction was "expressly conditioned" on the termination of the first transaction.[362]

i. Amounts Paid to Facilitate Mutually Exclusive Transactions. Separately, the same provision requires capitalization of an amount paid to facilitate a capital transaction as an amount paid to facilitate a second capital transaction but *only* if the transactions are "mutually exclusive."[363]

B. Transaction Costs – Business Acquisition and Capital Structure Changes – Simplifying Conventions. The business acquisition/capital structure change transaction cost capitalization rules adopt the same simplifying conventions adopted by the intangible capitalization rules of Reg. § 1.263(a)-4(e) with some modifications. Employee compensation (salary, bonus and commissions), overhead and *de minimis* costs are not required to be capitalized, except that the rule that amounts paid to persons who are not employees will be treated as "employee compensation" if paid for secretarial, clerical or similar administrative support services does not apply to services involving the preparation and distribution of proxy solicitations and other documents seeking shareholder approval of a capital transaction.[364] The Preamble explains that the

---

360 *Id.*

361 Reg. § 1.263(a)-5(c)(8). *See* Preamble, at 69 Fed. Reg. 442.

362 *See* Prop. Reg. § 1.263(a)-4(e)(1)(ii).

363 Reg. § 1.263(a)-5(c)(8).

364 Reg. § 1.263(a)-5(d)(2)(ii).

government believes that these are "inherently facilitative" services, which, when performed by independent contractors, are appropriately capitalizable.[365]

Consistent with the intangible transaction cost rules in Reg. § 1.263(a)-4 (which provide that the *de minimis* rule does not apply to commissions paid to facilitate the acquisition of certain financial interests), the Final Regulations at Reg. § 1.263(a)-5 provide that *de minimis* costs do not include commissions paid to facilitate a capital transaction.[366] Also consistent with Reg. § 1.263(a)-4, the Final Regulations at Reg. § 1.263(a)-5 allow the taxpayer to elect to capitalize employee compensation, overhead and *de minimis* costs.[367]

C. Transaction Costs – Business Acquisition and Capital Structure Changes – Special Rules for Certain Acquisitive Transactions. The Final Regulations, with some modifications, adopt two special rules introduced in the Proposed Regulations that are intended to achieve an objective standard in determining the capitalizable transaction costs of an acquisitive transaction.[368] In Rev. Rul. 99–23,[369] the Service ruled that costs incurred in the course of a general search for, or the investigation of, an active trade or business in order to determine *whether* to enter into a new trade or business and, if so, *which* trade or business, were amortizable under Section 195 (as a start-up expense over a 60-month period) rather than capitalizable under Section 263. In the Prop. Reg. Preamble, the Service expressed the view that the "whether and which" test of Rev. Rul. 99–23 has generated controversy between it and taxpayers.[370] In order to avoid that controversy, the Final Regulations adopt a "bright-line date" rule and an "inherently facilitative" rule, each requiring capitalization of expenditures incurred in connection with an acquisitive transaction. These rules apply only to the "covered transactions" described in the Final Regulations and identified below.[371]

---

365 Preamble, at 69 Fed. Reg. 442.
366 Reg. § 1.263(a)-5(d)(3)(ii); *See* Reg. § 1.263(a)-4(e)(4)(iii)(B).
367 Reg. § 1.263(a)-5(d)(4).
368 Preamble, at 69 Fed. Reg. 442.
369 1999–1 C.B. 32.
370 Prop. Reg. Preamble, at 67 Fed. Reg. 77706.
371 Reg. § 1.263(a)-5(e)(3).

1. Bright Line Date Rule. Under the bright line date rule, an amount paid to facilitate a "covered" transaction is required to be capitalized if it is incurred *after* the *earlier* of (i) the date on which a letter of intent, exclusivity agreement or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target or (ii) the date on which the material terms of the transaction (as tentatively agreed to by the representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer.[372] Where the transaction does not require board (or other governing officials') authorization or approval, the date is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.[373] The most significant costs captured by this rule are, of course, due diligence costs, which are required to be capitalized if incurred after the earlier such event occurs.

Some commentators criticized the introduction of the bright-line date rule in the Proposed Regulations, particularly because it ignores the facts and circumstances of the particular taxpayer and the specific transaction to which it applies, and questioned its enforceability on those grounds.[374] Other commentators generally have supported the bright-line date approach, noting that the event-based dates provide a reasonable proxy for the time at which most expenditures would be "inherently facilitative."[375] In the Preamble, the government, in response to the criticism of the bright line date rule, responded that, "… the IRS and Treasury Department continue to believe that a bright line rule is necessary to eliminate the subjectivity and controversy inherent in this area" and that "… the bright line rule is within the scope of the authority of the IRS and Treasury Department to prescribe rules necessary to enforce the requirements of section 263(a), and that the bright line rule … serves as an appropriate and objective standard for

---

[372] Reg. § 1.263(a)–5(e)(1)(i), (ii). The Preamble clarifies that the board approval date in the rule is not the date the board authorizes a committee (or management) to explore the possibility of a transaction or the date the board ratifies a shareholder vote approving the transaction. Preamble, at 69 Fed. Reg. 442.

[373] *Id.*

[374] *See*, *e.g.*, AICPA at 13.

[375] NYSBA at 9.

determining the point in time at which amounts paid in certain acquisitive transactions must be capitalized."[376]

In response to criticism that the bright line date should not be earlier than the date of board of directors approval (*i.e.*, the first prong of the rule should be eliminated), the government states in the Preamble that "… an earlier date is more appropriate where the parties have mutually agreed to pursue a transaction, notwithstanding the fact that the parties are not bound to complete the transaction.[377] In fact, the scope of the first prong of the bright-line date rule adopted by the Final Regulations is considerably tighter than that proposed in the Proposed Regulations, which designated "the date on which the would-be acquirer submits to the target a letter of intent, offer letter, or similar written communication proposing a merger, acquisition, or other business combination…."[378] The Final Regulations require a document *executed by both parties*, not merely a written proposal or offer from the acquirer. Thus, a taxpayer putting itself up for auction does not trigger the rule when a bid is received from a bidder.[379] Moreover, the Final Regulations clarify that a mere confidentiality agreement does not qualify.[380]

2. Inherently Facilitative Rule. Under the inherently facilitative rule, certain transaction expenses are treated as "inherently facilitative" of the acquisition and therefore are required to be capitalized for a "covered transaction" regardless of the time at which they are incurred.[381] The Final Regulations include a list, which is apparently exclusive, of the inherently facilitative costs, which are those costs incurred in:

> (i) securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;
>
> (ii) structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the

---

376 Preamble, at 69 Fed. Reg. 442.
377 *Id.*
378 *See* Prop. Reg. § 1.263(a)-4(e)(4)(i)(A)(1).
379 Preamble, at 69 Fed. Reg. 442.
380 Reg. § 1.263(a)-5(e)(1)(i).
381 Reg. § 1.263(a)-5(e)(2).

transaction (for example, obtaining tax advice on the application of Section 368);

(iii) preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement);

(iv) obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;

(v) obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or

(vi) conveying property between the parties to the transaction (for example, transfer taxes and title registration costs).[382]

The first item on the inherently facilitative list, "securing an appraisal, formal written evaluation or fairness opinion related to the transaction," is an improvement over the corresponding item in the Proposed Regulations, "activities performed in determining the value of the target."[383] The Preamble explains that "[c]ommentators expressed concerns that the language would require taxpayers to capitalize all due diligence costs. The final regulations tighten this category …. General due diligence costs are intended to be addressed by the bright line test, not the inherently facilitative rules."[384] The import of that commentary appears to be that none of the due diligence activities related to evaluating the target as an acquisition prospect are subject to the inherently facilitative rule (other than paying for the written approval, evaluation or fairness opinion).

The "covered transactions" that are governed by the bright-line date rule and by the inherently facilitative rule are the following:

382 *Id.*
383 *See* Prop. Reg. § 1.263(a)-4(e)(4)(i)(B).
384 Preamble, at 69 Fed. Reg. 443.

(i) A taxable acquisition by the taxpayer of assets that constitute a trade or business.

(ii) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of Section 267(b) or 707(b).

(iii) A reorganization described in Section 368(a)(1)(A), (B), or (C) or a reorganization described in Section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under Section 354 or 354 (whether the taxpayer is the acquirer or the target in the reorganization).[385]

The Final Regulations reserve the treatment of the target's transaction costs in a stock acquisition transaction.[386] In addition, success-based fees, such as fees of investment bankers, are treated as inherently facilitative except to the extent that documentation establishes that a portion of the fee is allocable to activities that do not facilitate the transaction.[387]

3. Amortization.

a. No Safe Harbor. The safe harbor amortization rules are made specifically inapplicable to business acquisition/capital structure change transaction costs governed by Reg. § 1.263(a)-5.[388]

b. Treatment of Taxable Acquisitions. The Final Regulations do not change current law with respect to the recovery of costs of a taxable acquisition.

---

385 Reg. § 1.263(a)-5(e)(3).
386 Reg. § 1.263(a)-5(g)(2)(ii)(B).
387 Reg. § 1.263(a)–5(f).
388 Reg. § 1.167(a)-3(b)(2).

The Final Regulations provide that, in the case of a taxable acquisition, merger or consolidation (*i.e.*, an acquisitive transaction not described in Section 368), the acquirer's capitalized transaction costs are added to the basis of the acquired assets or of the acquired stock,[389] while the target's capitalized transaction costs reduce its amount realized on the disposition of its assets.[390] Thus, the acquirer's costs of a taxable acquisitive transaction are recovered at well-established times, either through sale of the acquired stock or assets or the depreciation of the acquired assets. On the other hand, the target's costs in a stock sale may well never be recovered. A commentator has suggested that a recovery potential be created for such costs.[391]

In addition to reserving on the treatment of a target's capitalized transaction costs in a taxable stock sale, the Final Regulations also reserve on the treatment of capitalized transaction costs in tax-free transactions and stock issuance costs.[392] The Preamble explains that the government will issue separate guidance and at that time will consider whether such costs will be eligible for the 15-year safe harbor amortization.[393]

---

389 Reg. § 1.263(a)-5(g)(2)(i).

390 Reg. § 1.263(a)-5(g)(2)(ii)(A).

391 NYSBA at 16 (suggesting that such costs be recovered on sale or taxable liquidation of the target, because either indicates that the costs of the transaction no longer provide future benefit).

392 Reg. § 1.263(a)-5(g)(1), (3).

393 Preamble, at 69 Fed. Reg. 443. In the Prop. Reg. Preamble, the government requested public comment on the following: (1) Should an acquirer's capitalized transaction costs in a tax-free acquisition of a target be added to the acquirer's basis in the target's stock or assets acquired? If so, should amortization of such costs under the safe harbor amortization provision be prohibited on the ground that the capitalized costs are properly recovered as part of the recovery of the basis of the assets (in the case of a transaction treated as an asset acquisition) or upon the disposition of the stock (in the case of a transaction treated as a stock acquisition? On the other hand, if the carryover basis rules of section 362(b) of the Code prohibit the acquirer from increasing its basis in the acquired stock or assets by the amount of the capitalized transaction costs, should the capitalized transaction costs be viewed as a separate intangible asset with an indefinite useful life?; (2) Should a target's capitalized transaction costs in a tax-free acquisition that is treated as a stock acquisition be viewed as a separate intangible asset with an indefinite useful life?; (3) Should a target's capitalized transaction costs in a tax-free acquisition that is treated as an asset acquisition be viewed as an intangible asset with an indefinite useful life, or are such costs better viewed as a reduction of target's amount realized or as an increase in target's basis in its assets immediately prior to the acquisition?; (4) If an acquirer's (or a target's) capitalized transaction costs are viewed as a separate intangible asset with an indefinite useful life, should amortization be permitted for such costs under the safe harbor amortization provision, or does section 197(e)(8) of the Code evince a Congressional intent to prohibit any amortization of transaction costs capitalized in a tax-free reorganization?; (5) To what extent should the safe harbor amortization provision apply to capitalized transaction costs that facilitate tax-free transactions other than the acquisitive transactions discussed above (*e.g.*, transactions under sections 351 and 355)? Prop. Reg. Preamble, at 67 Fed. Reg. 77710.

4. Hostile Takeover Costs. The Proposed Regulations incorporated extensive rules regarding the treatment of the costs of defense against a hostile acquisition attempt ("hostile transaction rule"). Consistent with case law, the Proposed Regulations provided that hostile transactions costs are not required to be capitalized because they do not facilitate an acquisition.[394] The Proposed Regulations also provided that costs incurred in connection with a hostile transaction that becomes friendly are required to be capitalized to the extent incurred during the "friendly" portion of the transaction.[395] The Final Regulations have deleted those proposals entirely, as "unnecessary." The Preamble explains that the hostile transaction rule in the Proposed Regulations "does not permit taxpayers to deduct costs that otherwise would have been capitalized under the [final] regulations."[396]

> The IRS and Treasury Department decided that the rules in the proposed regulations for amounts paid to defend against a hostile takeover attempt are unnecessary. The hostile transaction rule in the proposed regulations does not permit taxpayers to deduct costs that otherwise would have been capitalized under the regulations. For example, the hostile transaction rule does not apply to any inherently facilitative costs or to costs that facilitate another capital transaction (for example, a recapitalization or a proposed merger with a white knight). Other amounts that a target would pay in defending against a hostile acquisition would not be capitalized under the final regulations either because the costs would not be paid in investigating or otherwise pursuing the transaction with the hostile acquirer (for example, costs to seek an injunction against the acquisition) or would relate to activities performed before the bright line dates (while the transaction is hostile, the target will not execute any agreements with the acquirer and the target's board of directors will not authorize the acquisition). Thus, the IRS and

[394] *See* Prop. Reg. § 1.263(a)–4(e)(4)(iii)(A). *See also, e.g., A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997).

[395] *See* Prop. Reg. § 1.263(a)–4(e)(4)(iii)(A).

[396] Preamble, at 69 Fed. Reg. 443.

> Treasury Department believe the hostile transaction rule in the proposed regulations is unnecessary and could cause needless controversy over when a transaction changes from hostile to friendly. Accordingly, the final regulations do not contain any special rules related to hostile acquisition attempts.[397]

VII. Conclusion. The Final Regulations are a commendable exercise in the regulatory management of chronic government-taxpayer conflict. The objective of simplicity and certainty have, for the most part, been substantially achieved.

---

397 *Id.*

TABLE OF CONTENTS

Page

I.
INTRODUCTION

A. The Basics – Capitalization Generally ... 1

B. Capitalization of Intangibles – the Cases Before and After *INDOPCO* ... 3

C. 2002 ANPRM ... 12

D. Proposed Regulations ... 12

E. Final Regulations ... 13

II.
THE FINAL REGULATIONS – SUMMARY OF PRINCIPAL FEATURES DIRECTED AT RESOLVING POST-*INDOPCO* CONTROVERSIES

A. Business Expansion ... 14

B. Operating Costs/Transactional Costs ... 14

C. Short-Term Benefits ... 14

D. Business Integration Costs ... 14

E. Hostile Takeover Defense Costs ... 14

F. Standstill Payments ... 14

G. Break-Up Fees ... 14

H. Investigatory/Due Diligence Costs for Acquisitive Transactions ... 15

III.
THE FINAL REGULATIONS – OVERVIEW

A. Structure ... 15

1. Capitalization Rules – Intangibles – Reg. § 1.263(a)-4 ... 15

2. Capitalization Rules – Business Acquisition and Capital Change Transaction Costs – Reg. § 1.263(a)-5 ... 16

3. Safe Harbor Amortization – Reg. § 1.167(a)-3(b) ... 16

4. Debt Issuance Costs – Reg. § 1.446-5 ... 16

B. Organization of Capitalization Rules for Intangibles – Reg. § 1.263(a)-4 ... 16

1. Acquisition/Creation Costs ... 16

2. Transaction Costs ... 17

3. 12–Month Rule ... 17

C. The Five Categories of Intangibles ... 17

1. Acquired Intangibles ... 17

TABLE OF CONTENTS
(continued)

Page

2. Created Intangibles 18
3. Separate and Distinct Intangible Assets 18
4. Future Benefits 21
5. Transaction Costs – Intangibles 23

D. Clear Reflection of Income 23
E. Coordination with other Code Provisions 23
F. Treatment of Capitalized Costs – Basis and Amortization 24
G. 12-Month Rule 25
1. In General 25
2. Exceptions 25
3. Contract Terminations 25
4. Indefinite Rights 26
5. Renewable Rights 26
a. Factors 26
b. Pools 27
6. Election to Capitalize 27

IV.
THE FINAL REGULATIONS – ACQUIRED AND CREATED INTANGIBLES

A. Acquired Intangibles 28
1. Ownership Interests 28
2. Debt Instruments 28
3. Financial Instruments 29
4. Annuities, etc 30
5. Non-functional currency 31
6. A lease 31
7. A patent or copyright 31
8. A franchise, trademark or tradename 32
9. An assembled workforce 32
10. Goodwill or going concern value 33
11. A customer list 33

TABLE OF CONTENTS
(continued)

Page

12. A servicing right ... 33
13. A customer-based intangible or a supplier-based intangible ... 34
14. Computer software ... 34
15. An agreement providing the right to use, possess or sell an intangible ... 35
16. Amounts Paid to Employees ... 36

B. Created Intangibles ... 36
1. Financial Interests ... 37
a. Ownership Interests ... 37
b. A Debt Instrument ... 38
c. Financial Instruments ... 38
d. Annuities, etc ... 41
e. Non-functional currency ... 41
2. Prepaid expenses ... 41
3. Certain memberships and privileges ... 43
4. Certain rights obtained from a governmental agency ... 44
5. Certain contract rights ... 46
6. Certain contract terminations ... 50
7. Certain benefits arising from the provision, production or improvement of real property ... 52
8. Defense or perfection of title to intangible property ... 55

V.
THE FINAL REGULATIONS – "TRANSACTION COSTS" UNDER REG. § 1.263(A)-4 (COSTS OF FACILITATING THE ACQUISITION OR CREATION OF AN INTANGIBLE)

A. Transaction Costs – "Facilitate." ... 56
B. Transaction Costs Under Reg. § 1263(a)-4 – Simplifying Conventions. ... 58
1. Employee Compensation and Overhead ... 58
2. Overhead ... 60
3. De Minimis Transaction Costs ... 60
4. Book-Tax Conformity Not Required ... 61
5. Clear Reflection of Income – Regular and Recurring Costs ... 61

TABLE OF CONTENTS
(continued)

Page

VI.
THE FINAL REGULATIONS – "TRANSACTION COSTS" UNDER
REG. § 1.263(A)-5 (COSTS OF FACILITATING THE ACQUISITION OF A TRADE OR BUSINESS OR A CHANGE IN CAPITAL STRUCTURE, ETC.)

A. Transaction Costs – Business Acquisition and Capital Structure Changes – General Rule 62

1. Transactions Covered..... 62

2. "Facilitate." 64

3. Special Rules..... 64

a. Borrowing Costs 64

b. Asset Sale Costs..... 65

c. Mandatory Stock Distributions..... 65

d. Bankruptcy Reorganization Costs..... 65

e. Stock Issuance Costs of Open-Ended Mutual Funds..... 66

f. Integration Costs 66

g. Registrar/Transfer Agent Fees 66

h. Costs Associated With Terminated Transactions – Break-Up Fees 67

i. Amounts Paid to Facilitate Mutually Exclusive Transactions 67

B. Transaction Costs – Business Acquisition and Capital Structure Changes – Simplifying Conventions 67

C. Transaction Costs – Business Acquisition and Capital Structure Changes – Special Rules for Certain Acquisitive Transactions 68

1. Bright Line Date Rule..... 69

2. Inherently Facilitative Rule..... 70

3. Amortization 72

a. No Safe Harbor 72

b. Treatment of Taxable Acquisitions..... 72

4. Hostile Takeover Costs 74

VII.
CONCLUSION