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DEPARTMENT OF THE TREASURY

Internal Revenue Service

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Guidance Regarding Deduction and Capitalization of Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: This document describes and explains rules and standards that the IRS and Treasury Department expect to propose in 2002 in a notice of proposed rulemaking that will clarify the application of section 263(a) of the Internal Revenue Code to expenditures incurred in acquiring, creating, or enhancing certain intangible assets or benefits. This document also invites comments from the public regarding these standards. All materials submitted will be available for public inspection and copying.

DATES: Written and electronic comments must be submitted by March 25, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-125638-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-125638-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue N.W., Washington, DC. Alternatively, taxpayers may send submissions electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html.

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Guy Traynor (202) 622-7180; concerning the proposals, Andrew J. Keyso (202) 927-9397 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

The IRS and Treasury Department are reviewing the application of section 263(a) of the Internal Revenue Code to expenditures that result in taxpayers acquiring, creating, or enhancing intangible assets or benefits. This document describes and explains rules and standards that the IRS and Treasury Department expect to propose in 2002 in a notice of proposed rulemaking.

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 taxable years. See Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974). Thus, the Supreme Court has held that expenditures that create or enhance separate and distinct assets or produce certain other future benefits of a significant nature must be capitalized under section 263(a). See INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).

The difficulty of translating general capitalization principles into clear, consistent, and administrable standards has been recognized for decades. See Welch v. Helvering, 290 U.S. 111, 114-15 (1933). Because courts focus on particular facts before them, the results reached by the courts are often difficult to reconcile and, particularly in recent years, have contributed to substantial uncertainty and controversy. The IRS and Treasury Department are concerned that the current level of uncertainty and controversy is neither fair to taxpayers nor consistent with sound and efficient tax administration.

Recently, much of the uncertainty and controversy in the capitalization area has related to expenditures that create or enhance intangible assets or benefits. To clarify the application of section 263(a), the forthcoming notice of proposed rulemaking will describe the specific categories of expenditures incurred in acquiring, creating, or enhancing intangible assets or benefits that taxpayers are required to capitalize. In addition, the forthcoming notice of proposed rulemaking will recognize that many expenditures that create or enhance intangible assets or benefits do not create the type of future benefits for which capitalization under section 263(a) is appropriate, particularly when the administrative and record keeping costs associated with capitalization are weighed against the potential distortion of income.

To reduce the administrative and compliance costs associated with section 263(a), the forthcoming notice of proposed rulemaking is expected to provide safe harbors and simplifying assumptions including a “one-year rule,” under which expenditures relating to intangible assets or benefits whose lives are of a relatively short duration are not required to be capitalized, and “de minimis rules,” under which certain types of expenditures less than a specified dollar amount are not required to be capitalized. The IRS and Treasury Department are also considering additional administrative relief, for example, by providing a “regular and recurring rule,” under which transaction costs incurred in transactions that occur on a regular and recurring basis in the routine operation of a taxpayer’s trade or business are not required to be capitalized.

The proposed standards and rules described in this document will not alter the manner in which provisions of the law other than section 263(a) (e.g., sections 195, 263(g), 263(h), or 263A) apply to determine the correct tax treatment of an item. Moreover, these standards and rules will not address the treatment of costs other than those to acquire, create, or enhance intangible assets or benefits, such as costs to repair or improve tangible property. The IRS and Treasury Department are considering separate guidance to address these other costs.

The following discussion describes the specific expenditures to acquire, create, or enhance intangible assets or benefits for which the IRS and Treasury Department expect to require capitalization in the forthcoming notice of proposed rulemaking. The IRS and Treasury Department anticipate that other expenditures to acquire, create, or enhance intangible assets or benefits generally will not be subject to capitalization under section 263(a).

A. <u>Amounts Paid to Acquire Intangible Property</u>

1. <u>Amounts paid to acquire financial interests</u>.

Under the expected regulations, capitalization will be required for an amount paid to purchase, originate, or otherwise acquire a security, option, any other financial interest described in section 197(e)(1), or any evidence of indebtedness. For a discussion of related transaction costs see section C of this document.

For example, a financial institution that acquires portfolios of loans from another person or originates loans to borrowers would be required to capitalize the amounts paid for the portfolios or the amounts loaned to borrowers.

2. Amounts paid to acquire intangible property from another person.

Under the expected regulations, capitalization will be required for an amount paid to another person to purchase or otherwise acquire intangible property from that person. For a discussion of related transaction costs see section C of this document.

For example, an amount paid to another person to acquire an amortizable section 197 intangible from that person would be capitalized. Thus, a taxpayer that acquires a customer base from another person would be required to capitalize the amount paid to that person in exchange for the customer base. On the other hand, a taxpayer that incurs costs to create its own customer base through advertising or other expenditures that create customer goodwill would not be required to capitalize such costs under this rule.

B. Amounts Paid to Create or Enhance Certain Intangible Rights or Benefits

1. 12-month rule.

The IRS and Treasury Department expect to propose a 12-month rule applicable to expenditures paid to create or enhance certain intangible rights or benefits. Under the rule, capitalization under section 263(a) would not be required for an expenditure described in the following paragraphs 2 through 8 unless that expenditure created or enhanced intangible rights or benefits for the taxpayer that extend beyond the earlier of

(i) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred.

The IRS and Treasury Department request comments on how the 12-month rule might apply to expenditures paid to create or enhance rights of indefinite duration and contracts subject to termination provisions. For example, comments are requested on whether costs to create contract rights that are terminable at will without substantial penalties would not be subject to capitalization as a result of the 12-month rule.

2. Prepaid items.

Subject to the 12-month rule, the IRS and Treasury Department expect to propose a rule that requires capitalization of an amount prepaid for goods, services, or other benefits (such as insurance) to be received in the future.

For example, a taxpayer that prepays the premium for a 3-year insurance policy would be required to capitalize such amount under the rule.

Similarly, a calendar year taxpayer that pays its insurance premium on December 1, 2002, for a 12-month policy beginning the following February would be required to capitalize the amount of the expenditure. The 12-month rule would not apply because the benefit attributable to the expenditure would extend beyond the end of the taxable year following the taxable year in which the expenditure was incurred. On the other hand, if the insurance contract had a term beginning on December 15, 2002, the taxpayer could deduct the premium expenditure under the 12-month rule because the benefit neither extends more than 12 months beyond December 15, 2002 (the first date the benefit is realized by the taxpayer) nor beyond the taxable year following the year the expenditure was incurred.

3. Certain market entry payments.

Subject to the 12-month rule, the IRS and Treasury Department expect to propose a rule that requires capitalization of an amount paid to an organization to obtain or renew a membership or privilege from that organization.

For example, subject to the 12-month rule, the rule would require capitalization of costs to obtain a stock trading privilege, admission to practice medicine at a hospital, and access to the multiple listing service. The rule does not contemplate requiring capitalization for costs to obtain ISO 9000 certification or similar costs.

4. Amounts paid to obtain certain rights from a governmental agency.

Subject to the 12-month rule, the IRS and Treasury Department expect to propose a rule that requires capitalization of an amount paid to a governmental agency for a trade name, trademark, copyright, license, permit, or other right granted by that governmental agency.

For example, under the rule, a restaurant would be required to capitalize the amount paid to a state to obtain a license to serve alcoholic beverages that is valid indefinitely.

5. Amounts paid to obtain or modify contract rights.

Subject to the 12-month rule, the IRS and Treasury Department expect to propose a rule that requires capitalization of amounts in excess of a specified dollar amount (e.g., $5,000) paid to another person to induce that person to enter into, renew, or renegotiate an agreement that produces contract rights enforceable by the taxpayer, including payments for leases, covenants not to compete, licenses to use intangible property, customer contracts and supplier contracts. The IRS and Treasury Department request comments on whether there are standards other than the standard described above that would be more appropriate for determining whether expenditures related to the creation or enhancement of contractual rights should be capitalized.

Subject to the 12-month rule, this rule would require a lessee to capitalize an amount paid to a lessor in exchange for the lessor's agreement to enter into a lease. This rule also would require a lessee to capitalize an amount paid to a lessor in exchange for the lessor's agreement to terminate a lease and enter into a new lease. See, e.g., U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998). However, this rule would not require a lessee to capitalize an amount paid to a lessor to terminate a lease where the parties do not enter into a new or renegotiated agreement. This rule also would not require a taxpayer to capitalize a payment that does not create enforceable contract rights but, for example, merely creates an expectation that a customer or supplier will maintain its business relationship with the taxpayer. See, e.g., Van Iderstine Co. v. Commissioner, 261 F.2d 211 (2nd Cir. 1958).

6. Amounts paid to terminate certain contracts.

Subject to the 12-month rule, the IRS and Treasury Department expect to propose a rule that requires capitalization of an amount paid by a lessor to a lessee to induce the lessee to terminate a lease of real or tangible personal property or by a taxpayer to terminate a contract that grants another person the exclusive right to conduct business in a defined geographic area.

For example, under the rule, a lessor that pays a lessee to terminate a lease of real property with a remaining term of 24 months would be required to capitalize such payment. See, e.g., Peerless Weighing and Vending Machine Corp. v. Commissioner, 52 T.C. 850 (1969). On the other hand, if the lease had a remaining term of 6 months, the 12-month rule would apply, and the taxpayer would not be required to capitalize the termination payment under the rule.

As a further example, where a taxpayer grants another person the exclusive right to develop the taxpayer's motel chain in four states, and the taxpayer later pays that other person to terminate such right at a time when the remaining useful life of the right is 5 years, the taxpayer would be required to capitalize the termination payment under the rule. See Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974).

7. Amounts paid in connection with tangible property owned by another.

Subject to the 12-month rule, the IRS and Treasury Department expect to propose a rule that requires capitalization of amounts in excess of a specified dollar amount paid to facilitate the acquisition, production, or installation of tangible property that is owned by a person other than the taxpayer where the acquisition, production, or installation of the tangible property results in the type of intangible future benefit to the taxpayer for which capitalization is appropriate. This rule would apply even though there is no contractual relationship between the taxpayer and the other person. This rule is intended to require capitalization of expenditures that produce intangible future benefits similar to those that were in issue in Kauai Terminal Ltd. v. Commissioner, 36

B.T.A. 893 (1937) (expenditure incurred to construct a publicly owned breakwater for the purpose of increasing taxpayer's freight lighterage operation). The IRS and Treasury Department request comments on standards that can be established to ensure that the expenditures described in this rule result in the type of future benefits that are similar to those in Kauai Terminal and therefore should be capitalized. The IRS and Treasury Department also request comments on whether safe harbors or dollar thresholds should be used to determine whether capitalization of such expenditures is appropriate under section 263(a).

8. Defense or perfection of title to intangible property.

Subject to the 12-month rule, the IRS and Treasury Department expect to propose a rule that requires capitalization of amounts paid to defend or perfect title to intangible property.

For example, under the rule, if a taxpayer and another person both claim title to a particular trademark, the taxpayer must capitalize any amount paid to the other person for relinquishment of such claim. See, e.g., J.I. Case Company v. United States, 32 F.Supp. 754 (Ct. Cl. 1940).

C. Transaction Costs

The IRS and Treasury Department expect to propose a rule that requires a taxpayer to capitalize certain transaction costs that facilitate the taxpayer's acquisition, creation, or enhancement of intangible assets or benefits described above (regardless of whether a payment described in sections A or B of this document is made). In addition, this rule would require a taxpayer to capitalize transaction costs that facilitate the taxpayer's acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of section 1060(c), or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. However, this rule would not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), fixed overhead (e.g., rent, utilities and depreciation), or costs that do not exceed a specified dollar amount, such as $5,000. The IRS and Treasury Department request comments on how expenditures should be aggregated for purposes of applying the de minimis exception, whether the de minimis exception should allow a deduction for the threshold amount where the aggregate transaction costs exceed the threshold amount, and whether there are certain expenditures for which the de minimis exception should not apply (e.g., commissions).

The IRS and Treasury Department are considering alternative approaches to minimize uncertainty and to ease the administrative burden of accounting for transaction costs. For example, the rules could allow a deduction for all employee compensation (including bonuses and commissions that are paid with respect to the transaction), be based on whether the transaction is regular or recurring, or follow the financial or regulatory accounting treatment of the transaction. The IRS and Treasury Department request comments on whether the recurring or nonrecurring nature of a transaction is an appropriate consideration in determining whether an expenditure to facilitate the transaction must be capitalized under section 263(a) and, if so, what criteria should be applied in distinguishing between recurring and nonrecurring transactions. In addition, the IRS and Treasury Department request comments on whether a taxpayer's treatment of transaction costs for financial or regulatory accounting purposes should be taken into account when developing simplifying assumptions.

For example, under the rule described above, a taxpayer would be required to capitalize legal fees in excess of the threshold dollar amount paid to its outside attorneys for services rendered in drafting a 3-year covenant not to compete because such costs facilitated the creation of the covenant not to compete. Similarly, the rule would require a taxpayer to capitalize legal fees in excess of the threshold dollar amount paid to its outside attorneys for services rendered in defending a trademark owned by the taxpayer.

Conversely, a taxpayer that originates a loan to a borrower in the course of its lending business would not be required to capitalize amounts paid to secure a credit history and property appraisal to facilitate the loan where the total amount paid with respect to that loan does not exceed the threshold dollar amount. The taxpayer also would not be required to capitalize the amount of salaries paid to employees or overhead costs of the taxpayer's loan origination department.

In addition, the rule would require a corporate taxpayer to capitalize legal fees in excess of the threshold dollar amount paid to its outside counsel to facilitate an acquisition of all of the taxpayer's outstanding stock by an acquirer. See, e.g., INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). However, the rule would not require capitalization of the portion of officers' salaries that is allocable to time spent by the officers negotiating the acquisition. Cf. Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000).

The rule also would not require capitalization of post-acquisition integration costs or severance payments made to employees as a result of an acquisition transaction because such costs do not facilitate the acquisition.

D. Other Items on Which Public Comment is Requested

1. Other costs of creating, acquiring or enhancing intangible assets or benefits that require capitalization.

The IRS and Treasury Department are considering what general principles of capitalization should be used to identify the costs of acquiring, creating, or enhancing intangible assets or benefits that should be capitalized under section 263(a) but are not described above. The IRS and Treasury Department anticipate that these general principles will apply in rare and unusual circumstances to require capitalization of costs that are similar to those described above. Comments are requested on capitalization principles (for example, a separate and distinct asset test or a significant future benefit test) that can be used to identify other costs that should be capitalized under section 263(a) and the administrability of such principles. The IRS and Treasury Department also request comments on other categories of costs associated with intangible assets or benefits that should be capitalized under section 263(a), but are not described above.

2. Book-Tax conformity.

The IRS and Treasury Department request comments on whether there are types of expenditures other than those discussed above for which the taxpayer's treatment for financial or regulatory accounting purposes should be taken into account in determining the treatment for federal income tax purposes or to simplify tax reporting.

3. Amortization periods.

Certain intangibles have readily ascertainable useful lives that can be determined with reasonable accuracy, while others do not. The IRS and Treasury Department expect to provide safe harbor recovery periods and methods for certain capitalized expenditures that do not have readily ascertainable useful lives. Comments are requested regarding whether guidance should provide one uniform period or multiple recovery periods and what the recovery periods and methods should be.

4. De minimis rules.

The IRS and Treasury Department request comments on whether there are types of expenditures other than those discussed above for which it would be appropriate to prescribe de minimis rules that would not require capitalization under section 263(a). If there are such categories or thresholds, comments are requested on how expenditures would be aggregated in applying these de minimis rules.

5. Costs of Software.

The IRS and Treasury Department request comments on what rules and principles should be used to distinguish acquired software from developed software and the administrability of those rules and principles. See Rev. Proc. 2000-50, 2000-2 C.B. 601.

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