INTERNAL REVENUE SERVICE

August 15, 2001

Number: **200147035**
Release Date: 11/23/2001
CC:ITA:03/TL-N-2486-01
UILC: 263.11-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, PHOENIX
ATTN JOHN W. DUNCAN CC:LM:NR:PHX

FROM: Associate Chief Counsel CC:ITA

SUBJECT: Graphic and Package Design Costs

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This Chief Counsel Advice responds to your memorandum dated May 17, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A	=
x	=
y	=
Product A	=
Product B	=
Product C	=
Product D	=
Tax Year 1	=
$A	=

ISSUE:

Whether this case is an appropriate vehicle for establishing that package and graphic design costs are capital expenditures.

CONCLUSION:

The Service believes that package and graphic design costs are capital expenditures, and that this case is an appropriate litigation vehicle.

FACTS:

A manufactures numerous consumer products, primarily but not exclusively in the area of x and y. Some of A's more recognizable brands include Product A, Product B, Product C and Product D.

On its Tax Year 1 return, A deducted $A as package design costs. A provided a breakdown of this amount for each product for which it incurred package or graphic design costs.

A described these costs as follows:

> The...package design costs...represent the non-capital costs incurred during Tax Year 1 to create, modify or otherwise change the graphic design and/or package design of A's products. Accordingly, the criterion used to determine whether a non-capital expenditure should be categorized as a Package Design Cost is whether such an expenditure creates or modifies the graphic design and /or package design of a product. Examples of Package Design Costs include, but are not limited to, art costs, graphics design costs, bottle reformulation costs, and label development costs. For this purpose, the term graphic design refers to the combination of information, styles of print, pictures, drawings, shapes, patterns, colors, spacing, and the like that make up an overall visual display of a product. The term package design refers to the design of the physical construction of the package.

The Service has stated the following about package designs: "A package design is developed when a product is first introduced and, although it may be modified occasionally, it is not usually changed on a regularly recurring basis. Further, the package design remains valuable for many years as the producer tries to establish both an enticing and uniquely recognizable package." Sara Lee Corporation, GCM 39483, I-135-85 (Dec. 16, 1985).

LAW:

Treas. Reg. § 1.162-20(a)(2) provides that expenditures for institutional or goodwill advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future.

In Rev. Rul. 89-23, 1989-1 C.B. 85, package design costs, defined as the cost of materials, labor and overhead associated with the design, including all design exploration and study, refinement of the basic design selected, testing and preparation of the final master comprehensive design, must be capitalized. Capitalization under section 263 is required because package designs generally have useful lives greater than one year.

Furthermore, the revenue ruling specifically provides that advertising expenditures are distinguishable from package design costs and are currently deductible either because they are of a recurring nature or because their benefit does not extend beyond the tax year.

In Rev. Rul. 92-80, 1992-2 C.B. 57, the Service sought to clarify that INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) does not affect the treatment of advertising costs under section 162(a). Service position is that advertising costs are generally deductible even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. Advertising costs would rarely have to be capitalized, and then only in the unusual circumstance where advertising is directed specifically towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising.

Rev. Proc. 98-39, 1998-1 C.B. 1320, modifying Rev. Proc. 97-35, 1997-2 C.B. 448, sets forth three alternative methods of capitalizing package design costs. The revenue procedure does not apply to the costs of a package design that is an amortizable intangible under section 197.

DISCUSSION:

Further litigation of this issue requires careful consideration of the Service's loss in the only other case litigated: RJR Nabisco, Inc. v. Commissioner, T.C. Memo. 1998-252. In that case, the Tax Court noted that the Commissioner's expert witness conceded that cigarette package graphic designs qualify as advertising under the accepted textbook definition of advertising, and further that the Commissioner did not dispute that graphic designs fit the textbook definition of advertising. The court held that the costs were advertising expenditures. From there, the court concluded that the advertising expenditures were ordinary business expenses. Further supporting the court's conclusion was its assertion that the Service had conceded the deductibility of advertising costs in Rev. Rul. 92-80, supra.

The RJR Nabisco Action in Decision recommends nonacquiescence and states that Rev. Rul. 92-80 should not be read as a concession that package design costs are advertising and, therefore, deductible. In Rev. Rul. 89-23, supra, the Service concluded that package design costs are capital expenditures and that package designs have an indeterminate useful life. Advertising costs are distinguishable from package design costs and are deductible either because they are of a recurring nature or because their benefit does not extend beyond the tax year.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted].

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