

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Regarding Deduction and Capitalization of Expenditures

REG-125638-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire, create, or enhance intangible assets. This document also contains proposed regulations under section 167 of the Code that provide safe harbor amortization for certain intangible assets, and proposed regulations under section 446 of the Code that explain the manner in which taxpayers may deduct debt issuance costs. Finally, this document provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by March 19, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for April 22, 2003, must be received by April 1, 2003.

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 4 p.m. to: CC:ITA:RU (REG-125638-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically via the IRS Internet site at: www.irs.gov/reg.s. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Andrew J. Keyso, (202) 927-9397; concerning submissions of comments, the

hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In recent years, much debate has focused on the extent to which section 263(a) of the Code requires taxpayers to capitalize amounts paid to acquire, create, or enhance intangible assets. On January 24, 2002, the IRS and Treasury Department published an advance notice of proposed rulemaking (ANPRM) in the **Federal Register** (67 FR 3461) announcing an intention to provide guidance in this area. The ANPRM described and explained rules under consideration by the IRS and Treasury Department and invited public comment on these rules.

Explanation of Provisions

I. Introduction

The proposed regulations under section 263(a) of the Code set forth a general principle that requires capitalization of certain amounts paid to acquire, create, or enhance intangible assets. In addition, the proposed regulations identify specific intangible assets for which capitalization is required under the general principle. These identified intangible assets are grouped into categories in the proposed regulations based on whether the intangible asset is acquired from another party or created by the taxpayer.

The proposed regulations also provide rules for determining the extent to which taxpayers must capitalize transaction costs that facilitate the acquisition, creation, or enhancement of intangible assets or that facilitate certain restructurings, reorganizations, and transactions involving the acquisition of capital. These transaction cost rules allow for the use of simplifying conventions intended to promote administrability and reduce the cost of compliance with section 263(a). In addition, the proposed regulations under section 167 of the Code provide a safe harbor amortization period applicable to certain created intangible assets that do not have readily ascertainable useful lives and for which an amortization period is not otherwise pre-

scribed or prohibited by the Code, regulations, or other published guidance.

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, create, or enhance a lease of real property. Several rules contained in the proposed regulations address amounts paid to acquire, create, or enhance leases of property, including leases of real property. The IRS and Treasury Department are considering future guidance addressing the treatment of amounts paid to acquire, create, or enhance tangible assets. Appropriate rules relating to the treatment of interests in land will be addressed in that future guidance.

II. General Principle of Capitalization

A. Overview

The proposed regulations require capitalization of amounts paid to acquire, create, or enhance an intangible asset. For this purpose, an *intangible asset* is defined as (1) any intangible that is acquired from another person in a purchase or similar transaction (as described in paragraph (c) of the proposed regulations); (2) certain rights, privileges, or benefits that are created or originated by the taxpayer and identified in paragraph (d) of the proposed regulations; (3) a separate and distinct intangible asset (as defined in paragraph (b)(3) of the proposed regulations); or (4) a future benefit that the IRS and Treasury Department identify in subsequent published guidance as an intangible asset for which capitalization is required. As discussed in Part V of this preamble, the proposed regulations also require capitalization of transaction costs that facilitate the acquisition, creation, or enhancement of an intangible asset or that facilitate a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, such as a stock issuance, borrowing, or recapitalization.

Through this definition of *intangible asset*, the IRS and Treasury Department seek to provide certainty for taxpayers by identifying specific categories of rights, privi-

leges, and benefits, the costs of which are appropriately capitalized. In determining the categories of expenditures for which capitalization is specifically required, the IRS and Treasury Department considered expenditures for which the courts have traditionally required capitalization. These categories will help promote consistent interpretation of section 263(a) by taxpayers and IRS field personnel.

B. *Separate and distinct intangible asset*

The proposed regulations define the term *separate and distinct intangible asset* based on factors traditionally used by the courts to determine whether an expenditure serves to acquire, create, or enhance a separate and distinct asset. 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 transferrable or salable; and (3) whether the expenditure creates anything with an ascertainable and measurable value in money's worth. See, e.g., *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 Springs National Bank v. United States*, 505 F.2d 1185, 1192 (10th Cir. 1974); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 784 (2nd Cir. 1973).

The proposed regulations provide that the determination of whether an amount serves to acquire, create, or enhance a separate and distinct intangible asset is made as of the taxable year during which the amount is paid, and not later using the benefit of hindsight.

The IRS and Treasury Department note that the separate and distinct asset standard has not historically yielded the same level of controversy as the significant future benefit standard. Moreover, several commentators suggested that, if the proposed regulations adopt a general principle of capitalization, the separate and distinct asset test is a workable principle in practice.

C. *Significant future benefits identified in published guidance*

A fundamental purpose of section 263(a) is to prevent the distortion of taxable income through current deduction of expen-

ditures 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 law. Consequently, the IRS and Treasury Department believe that simply restating the significant future benefit test, without more, would lead to continued uncertainty on the part of taxpayers and continued controversy between taxpayers and the IRS. Accordingly, 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.

The IRS and Treasury Department recognize, however, that there may be expenditures that are not identified in these categories, but for which capitalization is nonetheless appropriate. For this reason, the proposed regulations 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 expenditure 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 Part VII.A. of this preamble.

The IRS and Treasury Department believe that, by applying the significant fu-

ture 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. Upon finalization of the proposed regulations, the IRS expects to identify and withdraw existing capitalization guidance that is susceptible to application inconsistent with these regulations.

III. *Intangibles Acquired From Another*

Paragraph (c) of the proposed regulations requires capitalization of amounts paid to another party to acquire an intangible from that party in a purchase or similar transaction. This rule reflects well-settled law requiring capitalization of the purchase price (including sales taxes and similar charges) paid to acquire property from another. The regulations provide examples of intangibles that must be capitalized under this rule if the intangible is acquired from another person. Many of the intangibles required to be capitalized by this rule constitute "amortizable section 197 intangibles" eligible for 15-year amortization under section 197(a).

The rule does not address the treatment of any transaction costs the taxpayer may incur to facilitate the acquisition of an intangible from another party. The treatment of transaction costs is described in paragraph (e) of the proposed regulations. So, for example, while this rule requires capitalization of the amount paid to another party to acquire an intangible from that party, this rule does not describe the treatment of the various ancillary costs such as attorney fees and broker commissions incurred to facilitate the acquisition.

In addition, the rule applies only to acquired intangibles, and not to created intangibles. For example, the rule requires a taxpayer to capitalize the amount paid to acquire a customer base from another person. However, the rule does not require a taxpayer to capitalize costs that it incurs to create its own customer base.

IV. Created Intangibles

Paragraph (d) of the proposed regulations requires taxpayers to capitalize amounts paid to another party to create or enhance with that party certain identified intangibles discussed in Parts IV.A. through IV.H. of this preamble. Examples are included to demonstrate the scope of these rules.

To reduce the administrative and compliance costs associated with capitalizing these amounts, the proposed regulations adopt a “12-month rule” applicable to most created intangibles. Under this 12-month rule, a taxpayer is not required to capitalize amounts that provide benefits of a relatively brief duration. The 12-month rule is discussed in further detail in Part VI of this preamble.

As in the case of acquired intangibles, the rules in paragraph (d) relating to created intangibles address the amounts paid for the intangible itself, and not the related transaction costs incurred to facilitate the creation of the intangible. The treatment of transaction costs is described in paragraph (e) of the proposed regulations.

A. Financial interests

The proposed regulations require taxpayers to capitalize amounts paid to another party to create or originate with that party certain financial interests. The financial interests identified in the rule include interests in entities (e.g., corporations, partnerships, trusts) and financial instruments (e.g., debt instruments, notional principal contracts, options).

The 12-month rule does not apply to amounts paid to create or enhance a financial interest described in this rule, regardless of whether the amounts are also described in another part of paragraph (d) of the proposed regulations.

B. Prepaid expenses

In general, existing law requires capitalization of prepaid expenses. See, e.g., *Commissioner v. Boylston Market Ass’n*, 131 F.2d 966 (1st Cir. 1942). The proposed regulations require capitalization of amounts prepaid for benefits to be received in the future. The proposed regulations modify 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” in the ANPRM caused some readers to question whether the proposed rule is intended to apply to the acquisition of tangible property. The rule is not intended to apply to the acquisition of tangible property. 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. The IRS and Treasury Department decided to eliminate further confusion by modifying the rule to remove the explicit reference to goods.

Further, the reference in the rule to “benefits to be received in the future” is 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. As demonstrated by examples in the proposed regulations, the rule is intended merely to require capitalization of prepaid expenses.

C. Amounts paid to obtain certain memberships and privileges

The proposed regulations require taxpayers to capitalize amounts paid to an organization to obtain or renew a membership or privilege from that organization. The rule clarifies that amounts paid to obtain a quality certification of the taxpayer’s products, services, or business processes are not within the scope of the rule. Thus, for example, the rule does not require capitalization of amounts paid to obtain benefits such as ISO 9000 certification or Underwriters’ Laboratories Listing.

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

The proposed regulations require taxpayers to capitalize amounts paid to a governmental agency for a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency. In general, this rule is directed at the initial fee paid to a government agency. Under the 12-month rule, taxpayers are not required to capitalize annual renewal fees paid to the government agency. An example in the proposed regulations demonstrates this point.

These regulations do 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 that agency is not required to be capitalized under this section if the amount is deductible under section 174.

E. Amounts paid to obtain or modify contract rights

The proposed regulations require taxpayers to capitalize amounts (other than *de minimis* amounts) paid to another party to induce that party to enter into, renew, or renegotiate an agreement that produces certain rights for the taxpayer. This rule recognizes that some agreements produce contract rights that are reasonably certain to produce future benefits for the taxpayer, or for which courts have traditionally required capitalization. For example, the rule requires capitalization of amounts paid to enter into or renegotiate a lease contract or a contract providing the taxpayer the right to acquire or provide services. The rule also requires capitalization of an amount paid to obtain a covenant not to compete. Recognizing that employment contracts often are entered into along with covenants not to compete, the proposed regulations contain a rule similar to that in § 1.197-2(b)(9) of the regulations. An agreement for the performance of services does not have substantially the same effect as a covenant not to compete and, accordingly, amounts paid for personal services actually rendered are not required to be capitalized under this rule.

On the other hand, the rule recognizes that many agreements do not produce contract rights for which capitalization is appropriate. Thus, the rule does not require a taxpayer to capitalize an amount that merely creates an expectation that a customer or supplier will maintain its business relationship with the taxpayer.

The rule contains a *de minimis* exception under which inducements that do not exceed \$5,000 are not required to be capitalized. The IRS and Treasury Department request comments on whether a non-cash inducement is properly valued at the taxpayer’s cost to acquire or produce the inducement, or at the fair market value of the inducement. If the non-cash inducement is properly valued at its fair market value, comments are requested regarding the treatment of any gain or loss realized on the transfer of the non-cash inducement.

This rule and the financial interests rule (described in Part IV.A. of this preamble) 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 principle of capitalization on the theory that the agreement is a separate and distinct intangible asset.

F. Amounts paid to terminate certain contracts

The proposed regulations require taxpayers to capitalize an amount paid to terminate three types of contracts. The purpose of the rule is to require capitalization of termination payments that enable the taxpayer to reacquire some valuable right it did not possess immediately prior to the termination. Thus, capitalization is required for payments by a lessor to terminate a lease agreement with a lessee. See *Peerless Weighing and Vending Machine Corp. v. Commissioner*, 52 T.C. 850 (1969). Capitalization also is required for payments by a taxpayer to terminate an agreement that provides another party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business. See *Rodeway Inns of America v. Commissioner*, 63 T.C. 414 (1974). Finally, capitalization is required for payments to terminate an agreement that prohibits the taxpayer from competing with another or from acquiring property or services from a competitor of another.

On the other hand, the rule does not require capitalization in cases where the taxpayer, as a result of the termination, does not reacquire a right for which capitalization is appropriate. For example, the rule does not require a taxpayer to capitalize a payment to terminate a supply contract with a supplier, and does not require a lessee to capitalize a payment to terminate a lease agreement with a lessor. This also is consistent with existing law. See, e.g., *Stuart Co. v. Commissioner*, 195 F.2d 176 (9th Cir. 1952), aff'd 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.

The proposed regulations modify, in several respects, the rule described in the ANPRM. First, the proposed regulations expand the rule to require capitalization of an amount paid to terminate a contract that grants another the exclusive right to ac-

quire or use the taxpayer's property or services. Thus, a taxpayer must capitalize amounts paid to terminate an exclusive license to use the taxpayer's property. Second, the proposed regulations remove the reference to a defined geographic area from the rule requiring capitalization of amounts paid to terminate an agreement that provides another party the exclusive right to conduct the taxpayer's business. The IRS and Treasury Department are concerned that this reference may lead to uncertainty regarding whether the parties intended for a particular right to be limited to a defined geographic area, especially where the agreement is silent regarding geographic area. Third, as discussed above, the proposed regulations require a taxpayer to capitalize an amount paid to another to terminate an agreement that prohibits the taxpayer from competing with another.

G. Amounts paid to acquire, produce, or improve real property owned by another

The proposed regulations require taxpayers to capitalize an amount paid to acquire real property that is relinquished to another, or to produce or improve real property that is owned by another, if the real property is reasonably expected to produce significant economic benefits for the taxpayer. The purpose of this rule is to recognize a long line of cases and rulings that require capitalization where the taxpayer provides property to another or improves property of another with the expectation that the property will provide significant future benefits for the taxpayer. See *D. Loveman & Son 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 benefitted the taxpayer's business and were appropriately capitalized); *Chicago and 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, 1969-1 C.B. 86 (expenditures incurred by a railroad com-

pany 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).

The proposed regulations limit the scope of the rule to real property, and not to all tangible property as originally contemplated by the ANPRM. Some courts have required capitalization on the ground that an intangible asset is created where the taxpayer provides tangible personal property to another. See, e.g., *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; the expenditure created valuable benefits that would benefit the taxpayer beyond the taxable year). Nonetheless, the IRS and Treasury Department are reluctant to extend the rule to cases involving tangible personal property. Inclusion of personal property within the scope of the rule would require capitalization of many expenditures that are properly deductible under current law, such as advertising or business promotion costs.

The proposed regulations clarify that the rule is not intended to apply where the taxpayer is selling the real property, is providing the real property to another as payment for some other property or service provided to the taxpayer, or is selling services to produce or improve the property. The proposed regulations also clarify that the rule is not intended to change the result in Rev. Rul. 2002-9, 2002-10 I.R.B. 614, regarding the treatment of impact fees paid by a developer of real property. Rev. Rul. 2002-9 provides that impact fees incurred by a taxpayer in connection with the construction of real property are capitalized costs allocable to the real property. The proposed regulations provide that these costs do not create an intangible asset for which capitalization is required by this rule. Similarly, the proposed regulations provide that real property turned over to a government entity in connection with a real estate development project (dedicated improvements) also are outside the scope of this rule. Such costs are allocable to the prop-

erty produced, as provided in section 263A and the regulations thereunder.

For costs required to be capitalized under this rule, the proposed regulations under section 167 permit safe harbor amortization ratably over a 25-year period. The IRS and Treasury Department did not adopt the approach suggested by commentators of permitting amortization over the recovery period prescribed for the property under section 168 as if the taxpayer had actually owned the real property and used it in its trade or business. The IRS and Treasury Department believe that such an approach would raise difficult questions regarding the appropriate class life or recovery period to be applied. In addition, such an approach would not address the treatment of property for which a class life or recovery period is not prescribed by section 168, such as vacant land. The 25-year safe harbor will eliminate the uncertainty that would otherwise exist if amortization were permitted over the period of the expected future benefit. The IRS and Treasury Department invite comments on this safe harbor amortization provision.

H. Amounts paid to defend or perfect title to intangible property

The proposed regulations require taxpayers to capitalize an amount paid to another party to defend or perfect title to intangible property where the other party challenges the taxpayer's title to the intangible property. This is consistent with existing regulations under section 263(a) of the Code. See § 1.263(a)-2(c). The rule is not intended to require capitalization of amounts paid to protect the property against infringement and to recover profits and damages as a result of an infringement. As under current law, these costs are generally deductible. See, e.g., *Urquhart v. Commissioner*, 215 F.2d 17 (3rd 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). 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.

V. Transaction Costs

A. In general

The proposed regulations provide a two-pronged rule that requires taxpayers to capitalize transaction costs. The first prong of the rule requires capitalization of transaction costs that facilitate the taxpayer's acquisition, creation, or enhancement of an intangible asset. The second prong of the rule requires capitalization of transaction costs that facilitate the taxpayer's restructuring or reorganization of a business entity or facilitate a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.

The first prong of the transaction cost rule recognizes that capitalization is required not only for the cost of an asset itself, but for the ancillary expenditures incurred in acquiring, creating, or enhancing the intangible asset. *Woodward v. Commissioner*, 397 U.S. 572 (1970). The proposed regulations require that taxpayers capitalize these transaction costs to the basis of the intangible asset acquired, created, or enhanced.

The second prong of the transaction cost rule recognizes that transaction costs that effect a change in the taxpayer's capital structure create betterments of a permanent or indefinite nature and are appropriately capitalized. See *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992) (professional fees incurred by a target corporation in a stock acquisition); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712 (8th Cir. 1964) (costs to issue a stock dividend to shareholders); *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244 (2nd Cir. 1953) (professional fees incurred in a recapitalization). As discussed in further detail in Part VII of this preamble (relating to safe harbor amortization), the proposed regulations do not address whether these costs increase the taxpayer's basis in property or are treated as a separate intangible asset. Comments are requested on these issues. However, in the case of transaction costs that facilitate a stock issuance or recapitalization, the proposed regulations are consistent with existing law, which provides that such capital expenditures do not create a separate intangible asset, but instead offset the proceeds of the stock issuance. See Rev. Rul. 69-330, 1969-1 C.B. 51; *Affiliated Capital Corp. v. Commissioner*, 88 T.C. 1157 (1987). The

proposed regulations provide that capitalization is not required under this provision for stock issuance costs of open-end regulated investment companies (other than those costs incurred during the initial stock offering period). See Rev. Rul. 94-70, 1994-2 C.B. 17.

As discussed in Part VII of this preamble, costs required to be capitalized under the second prong of the transaction cost rule are not eligible for the safe harbor amortization provision provided in the regulations. However, comments are requested on whether the safe harbor amortization provision should apply to any of these costs.

The term *reorganization* as used in the second prong of the transaction cost rule contemplates a reorganization in the broad sense of a change to an entity's capital structure, and not merely a transaction that constitutes a tax-free reorganization under the Code. The terms *reorganization* and *restructuring* are broad enough to include transactions under section 351 of the Code, as well as bankruptcy reorganizations. While the term is broad enough to encompass stock redemptions, the treatment of costs incurred in connection with a stock redemption is specifically prescribed by section 162(k). The terms *reorganization* and *restructuring* are not intended to refer to mere changes in an entity's business processes, commonly referred to as "re-engineering." Thus, a taxpayer's change from a batch inventory processing system to a "just-in-time" inventory processing system, regardless of whether the taxpayer refers to such change as a business "restructuring," is not within the scope of the rule, as demonstrated by example in the proposed regulations.

Consistent with existing law, the rule requires capitalization of costs to facilitate a divisive transaction. See *Bilar Tool & Die Corp. v. Commissioner*, 530 F.2d 708 (6th Cir. 1976). However, the rule does not require capitalization of amounts paid to facilitate a divisive transaction where the divestiture is pursuant to a government mandate, unless the divestiture is a condition of permitting the taxpayer to participate in a separate restructuring or reorganization transaction. See, e.g., *El Paso Co. v. United States*, 694 F.2d 703 (Fed Cir. 1982); *American Stores Co. v. Commissioner*, 114 T.C. 458 (2000).

In the ANPRM, the second prong of the transaction cost rule applied to "an appli-

cable asset acquisition within the meaning of section 1060(c).” This language caused confusion as to whether the second prong of the transaction cost rule applied to acquisitions of tangible assets. To clarify that the transaction cost rules do not apply to acquisitions of tangible assets (other than acquisitions of real property described in Part IV.G. of this preamble) the proposed regulations delete the reference to section 1060(c). To the extent that intangible assets are acquired in an applicable asset acquisition under section 1060(c), the first prong of the transaction cost rule requires capitalization of transaction costs that facilitate the acquisition of those intangible assets. Transaction costs allocable to tangible assets are capitalized to the extent provided by existing law. The IRS and Treasury Department are considering separate guidance to address the treatment of expenditures to acquire, create, or enhance tangible assets.

B. Facilitate

The proposed regulations provide a “facilitate” standard for purposes of determining whether transaction costs must be capitalized. 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 merged businesses, 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. The proposed regulations provide that an amount facilitates a transaction if it is incurred in the process of pursuing the acquisition, creation, or enhancement of an intangible asset or in the process of pursuing a restructuring, reorganization, or transaction involving the acquisition of capital.

In response to the ANPRM, commentators suggested that the proposed regulations should distinguish costs to facilitate the acquisition of a trade or business from costs to investigate the acquisition of a trade or business. Several commentators suggested that the proposed regulations should adopt the standard contained in Rev. Rul. 99-23, 1999-1 C.B. 998.

Rev. Rul. 99-23 provides a “whether-and-which” test for distinguishing costs to investigate the acquisition of a new trade or business (which are amortizable under section 195) from costs to facilitate the acquisition (which are capital expenditures under section 263(a) and are not amortizable under section 195). Under this test, costs incurred to determine whether to acquire a new trade or business, and which new trade or business to acquire, are investigatory costs. Costs incurred in the attempt to acquire a specific business are costs to facilitate the consummation of the acquisition.

Because Rev. Rul. 99-23 has created controversy between taxpayers and the IRS, the proposed regulations do not adopt the standard contained in Rev. Rul. 99-23. Rather, the proposed regulations provide, as a bright line rule, that an amount paid in the process of pursuing an acquisition of a trade or business (whether the acquisition is structured as an acquisition of stock or of assets and whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) is required to be capitalized only if the amount is “inherently facilitative” or if the amount relates to activities performed after the earlier of the date a letter of intent (or similar communication) is issued or the date the taxpayer’s Board of Directors approves the acquisition proposal. For this purpose, the proposed regulations identify amounts that are inherently facilitative (*e.g.*, amounts relating to determining the value of the target, drafting transactional documents, or conveying property between the parties). Under this bright line rule, an amount that does not facilitate the acquisition is not required to be capitalized under this section. The proposed regulations do not affect the treatment of start-up expenditures under section 195. The IRS and Treasury Department are considering the application of these bright line standards to tangible assets acquired as part of a trade or business in order to provide a single administrable standard in these transactions. The IRS and Treasury Department request comments on whether the bright line standard provided in the proposed regulations is administrable and whether there are other bright line standards that can be applied in this area.

The proposed regulations provide that a success-based fee is an amount paid to fa-

cilitate the acquisition except to the extent that evidence clearly demonstrates that some portion of the amount is allocable to activities that do not facilitate the acquisition. The IRS and Treasury Department request comments on the treatment of success-based fees.

The IRS and Treasury Department stress that section 6001 of the Code requires taxpayers to maintain sufficient records to support a position claimed on the taxpayer’s return. Thus, taxpayers must maintain records adequate to document that amounts relate to activities performed prior to the bright line date. Comments are requested on the types of records that are available in the context of an acquisition of a trade or business and how these records might be utilized to administer the bright line rule.

C. Hostile takeover defense costs

The proposed regulations provide that transaction costs incurred by a taxpayer to defend against a hostile takeover of the taxpayer’s stock do not facilitate the acquisition and therefore are not required to be capitalized. See *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997). The proposed regulations recognize, however, that an initially hostile acquisition attempt may eventually become friendly. In such a case, the rules require the taxpayer to bifurcate its costs between those incurred to defend against the acquisition attempt at the time the attempt was hostile and those incurred to facilitate the friendly acquisition. Capitalization is required for costs incurred to facilitate the friendly acquisition. The IRS and Treasury Department request comments on rules that might be applied to determine the point at which a hostile acquisition attempt becomes friendly.

Some costs may be viewed both as costs to defend against a hostile acquisition and as costs to facilitate another capital transaction. For example, a taxpayer may attempt to thwart a hostile acquisition by merging with a white knight, recapitalizing, or issuing stock purchase rights to existing shareholders. The proposed regulations require capitalization of such costs, regardless of whether the taxpayer’s purpose in incurring such costs was solely to defend against a hostile acquisition.

D. Simplifying conventions applicable to transaction costs

1. Salaries and Overhead

Much of the recent debate surrounding 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. Generally, courts and the Service have required capitalization of such costs where the facts show that the costs clearly are allocable to a particular asset. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1973) (requiring capitalization of depreciation on equipment used to construct capital assets and noting that wages, when paid in connection with the construction or acquisition of a capital asset, must be capitalized and amortized over the life of the capital asset); *Louisville and N.R. Co. v. Commissioner*, 641 F.2d 435 (6th Cir. 1981) (requiring capitalization of overhead costs associated with building and rebuilding railroad freight cars); *Lychuk v. Commissioner*, 116 T.C. 374 (2001) (requiring capitalization of employee compensation where employees spent a significant portion of their time working on acquisitions of installment obligations); Rev. Rul. 73-580, 1973-2 C.B. 86 (requiring capitalization of employee compensation reasonably attributable to services performed in connection with corporate mergers and acquisitions).

In the context of intangible assets, some courts have allowed taxpayers to deduct employee compensation and overhead where there is only an indirect nexus between the intangible asset and the compensation or overhead. See *Wells Fargo v. Commissioner*, 224 F.3d 874 (8th Cir. 2000) (deduction allowed for officers' salaries allocable to work performed by corporate officers in negotiating a merger transaction because the salaries "originated from the employment relationship between the taxpayer and its officers" and not from the merger transaction); *PNC Bancorp v. Commissioner*, 212 F.3d 822 (3rd Cir. 2000) (deduction allowed for compensation and other costs of originating loans to borrowers); *Lychuk v. Commissioner*, 116 T.C. 374 (2001) (capitalization not required for overhead costs allocable to the taxpayer's acquisition of installment loans because the overhead did not originate in the process of acquiring the installment notes, and would

have been incurred even if the taxpayer did not engage in such acquisition).

To resolve much of this controversy, and to eliminate the burden on taxpayers of allocating certain transaction costs among various intangible assets, the proposed regulations provide a simplifying assumption that employee compensation and overhead costs do not facilitate the acquisition, creation or enhancement of an intangible asset. The rule applies regardless of the percentage of the employee's time that is allocable to capital transactions. For example, capitalization is not required for compensation paid to an employee of the taxpayer who works full time on merger transactions.

The proposed regulations modify the rule proposed in the ANPRM by extending the scope of the rule to all employee compensation, whether paid in the form of salary, bonus, or commission. Commentators noted that bonuses are rarely paid with respect to one particular transaction, and a requirement to capitalize bonuses would not result in simplification given the necessity of allocating bonuses among capital transactions. In the case of overhead, the proposed regulations modify the rule proposed in the ANPRM by extending the scope of the rule to variable overhead. The IRS and Treasury Department have concluded that the clearer reflection of income that might be gained by requiring capitalization of employee compensation and overhead does not offset the administrative and record keeping burdens imposed by a capitalization requirement.

These simplifying conventions are intended to be rules of administrative convenience, and not substantive rules of law. Accordingly, in the case of employee compensation and overhead, the IRS and Treasury Department are considering limiting the application of the simplifying conventions to taxpayers that deduct these costs for financial accounting purposes. Under this approach, the simplifying conventions for employee compensation and overhead would not apply to taxpayers that capitalize these costs for financial accounting purposes. A book-tax conformity rule would recognize that there is no simplification gained by allowing a deduction for employee compensation and overhead where the taxpayer allocates these costs to intangible assets and capitalizes them for financial accounting purposes. The IRS and

Treasury Department anticipate that any such book-tax conformity rule would not apply to *de minimis* costs.

The proposed regulations do not presently include a book-tax conformity rule. However, the IRS and Treasury Department request comments on whether the final regulations should apply a book-tax conformity rule to employee compensation and overhead.

2. De Minimis Costs

The proposed regulations provide that *de minimis* transaction costs do not facilitate a capital transaction and therefore are not required to be capitalized. The rule defines *de minimis* costs as costs that do not exceed \$5,000. The IRS and Treasury Department considered whether the *de minimis* rule should be based on the taxpayer's gross receipts, total assets, or some other variable benchmark, rather than a fixed amount. The IRS and Treasury Department decided not to adopt such an approach because of concern that it would add complexity and create administrability issues, particularly where the benchmark amount changes as a result of amended returns or audit adjustments.

The proposed regulations clarify that the *de minimis* rule applies on a transaction-by-transaction basis. As demonstrated by examples in the proposed regulations, a single transaction may involve the acquisition of multiple intangible assets. The proposed regulations also clarify that if transaction costs (other than compensation and overhead) exceed \$5,000, no portion of the costs is considered *de minimis* under the rule. Thus, all of the costs (not just the cost in excess of \$5,000) must be capitalized. The IRS and Treasury Department request comments on whether additional rules are required to prevent taxpayers from improperly fragmenting agreements or transactions to take advantage of the *de minimis* rules contained in the proposed regulations.

The proposed regulations contain rules for aggregating costs allocable to a transaction. While taxpayers generally must account for the actual costs allocable to each transaction, the proposed regulations permit taxpayers to determine the applicability of the *de minimis* rules by computing the average transaction cost for a pool of similar transactions. The IRS and Treasury Department recognize that this average cost pooling method could result in a

skewed average cost where several unusually large transactions occur during the year and request comments on how to address such transactions. If the final regulations ultimately provide this pooling mechanism for computing average transaction costs, taxpayers are reminded of their obligations under section 6001 of the Code to maintain such records as are sufficient to establish the amount of any deductions claimed as *de minimis* costs.

The proposed regulations provide that the *de minimis* rule does not apply to commissions paid to acquire or create certain financial interests. Accordingly, taxpayers must capitalize such commissions. The IRS and Treasury Department note that the treatment of commissions is well-settled under existing law. See *Helvering v. Winnmill*, 305 U.S. 79 (1938); § 1.263(a)–2(e). In addition, because commissions generally are traceable to a particular acquisition or creation, no simplification is gained by treating commissions as *de minimis* costs.

3. Regular and Recurring Costs

The ANPRM requested public comment on whether the recurring or nonrecurring nature of a transaction is an appropriate consideration in determining whether an expenditure incurred to facilitate a transaction must be capitalized under section 263(a) and, if so, what criteria should be applied in distinguishing between recurring and nonrecurring transactions. The IRS and Treasury Department considered the public comments and concluded that a regular and recurring rule would likely be too vague to be administrable. The IRS and Treasury Department believe that the simplifying conventions for employee compensation, overhead, and *de minimis* costs address the types of regular and recurring costs that are most appropriately excluded from capitalization. Thus, a regular and recurring rule is not provided in the proposed regulations.

VI. 12-Month Rule

A. In general

The existing regulations under sections 263(a), 446, and 461 require taxpayers to capitalize expenditures that create an asset having a useful life substantially beyond the close of the taxable year. See §§ 1.263(a)–2(a), 1.446–1(c)(1)(ii), and 1.461–1(a)(2)(i). In determining whether an

asset has a useful life substantially beyond the close of the taxable year, some courts have adopted a “one-year” rule. *U.S. Freightways Corp. v. Commissioner*, 270 F.3d 1137 (7th Cir. 2001), rev’g 113 T.C. 329 (1999); *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980). Under this rule, an expenditure may be deducted in the year it is incurred, as long as the benefit resulting from the expenditure does not have a useful life that extends beyond one year.

The IRS and Treasury Department think that a “12-month” rule would help to reduce the administrative and compliance costs inherent in applying section 263(a) to amounts paid to create or enhance intangible assets. Accordingly, under the proposed regulations, certain amounts (including transaction costs) paid to create or enhance intangible rights or benefits for the taxpayer that do not extend beyond the period prescribed by the 12-month rule are treated as having a useful life that does not extend substantially beyond the close of the taxable year. Thus, such amounts are not required to be capitalized under the proposed regulations. Amounts paid to create rights or benefits that do extend beyond the period prescribed by the 12-month rule must be capitalized in full; no portion of these amounts is considered to come within the scope of the 12-month rule on the ground that such portion is allocable to rights or benefits that will expire within the period prescribed by the 12-month rule.

The 12-month rule does not apply to amounts paid to create or enhance financial interests or to amounts paid to create or enhance self-created amortizable section 197 intangibles (as described in section 197(c)(2)(A)). Application of the 12-month rule to self-created amortizable section 197 intangibles, but not to amortizable section 197 intangibles acquired from another person, would result in inconsistent treatment of amortizable section 197 intangibles. The IRS and Treasury Department are reluctant to treat acquired amortizable section 197 intangibles different from self-created amortizable section 197 intangibles.

The proposed regulations clarify the interaction of the 12-month rule with the economic performance rules contained in section 461(h) of the Code. Nothing in these proposed regulations is intended to change the application of section 461 of the Code,

including the application of the economic performance rules. In the case of a taxpayer using the accrual method of accounting, section 461 requires that an item be incurred before it is taken into account through capitalization or deduction. For example, under the economic performance rules, amounts prepaid for goods or services generally are not incurred, and therefore may not be taken into account by an accrual method taxpayer, until such time as the goods or services are provided to the taxpayer (subject to the recurring item exception). § 1.461–4(d)(2)(i). Thus, the 12-month rule provided by the regulations does not permit an accrual method taxpayer to deduct an amount prepaid for goods or services where the amount has not been incurred under section 461 (for example, where the taxpayer can not reasonably expect that it will be provided goods or services within 3½ months after the date of payment). The proposed regulations contain examples demonstrating the interaction of the 12-month rule with the economic performance rules of section 461(h).

B. Application of 12-month rule to contract terminations

The proposed regulations clarify that, for purposes of applying the 12-month rule, an amount paid to terminate a contract described in Part IV.F. of this preamble prior to its expiration date creates a benefit for the taxpayer equal to the unexpired term of the agreement as of the date of termination. Thus, for example, if a lessor incurs costs to terminate a lease with an unexpired term of 10 months, the 12-month rule will apply to those costs.

C. Rights of indefinite duration

The 12-month rule does not apply to contracts or other rights that have an indefinite duration. Rights of indefinite duration include rights that have no period of duration fixed by agreement or law or that are not based on a period of time, but are based on a right to provide or receive a fixed amount of goods or services. The IRS and Treasury Department believe that, in many cases, application of the 12-month rule to contracts or other rights that are not based on a period of time would necessitate speculation regarding whether the contract or other right could reasonably be expected to be completed within 12 months. In addition, the IRS and Treasury Depart-

ment believe that amounts paid to create or enhance such rights should be capitalized and recovered through amortization, through a loss deduction upon abandonment of the right, or through basis recovery upon sale.

Further, § 1.167(a)–14(c) of the regulations provides rules for amortizing costs to obtain a right to receive a fixed amount of property or services. Under these rules, the basis of such right is amortized for each taxable year by 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 terms of the contract. The IRS and Treasury Department believe that these amortization rules provide a reasonable recovery method for many rights that are required to be capitalized under these regulations, and serve as a sufficient substitute for a 12-month rule.

D. Rights that are renewable

The proposed regulations provide rules for determining whether renewal periods should be taken into account in determining the treatment of a renewable contract with an initial term that falls within the scope of the 12-month rule. The proposed regulations provide that renewal periods are to be taken into account if there is a “reasonable expectancy of renewal.” Some commentators suggested that renewals should be taken into account only if renewal is “substantially likely” or “economically compelled.” The IRS and Treasury Department believe that the reasonable expectancy of renewal test is a more appropriate standard, and note that this standard is consistent with the standard provided in § 1.167(a)–14(c)(3) of the regulations for purposes of determining the amortization period for certain contract rights.

Whether a reasonable expectancy of renewal exists depends on all relevant facts and circumstances in existence at the time the contract or other right is created. The fact that a particular contract is ultimately renewed is not relevant in determining whether a reasonable expectancy of renewal exists at the time the parties entered into the contract. The proposed regulations provide factors that are significant in determining whether a reasonable expectancy of renewal exists.

The IRS and Treasury Department are considering rules that permit taxpayers who create, renew, or enhance a certain minimum number of similar rights or benefits during a taxable year to pool those transactions for purposes of applying the 12-month rule. The proposed regulations provide a broad outline of one pooling method under consideration by the IRS and Treasury Department. This method allows taxpayers to apply the reasonable expectancy of renewal test to pools of similar rights or benefits. Under this proposed method, taxpayers are required to capitalize an expenditure to obtain a right or benefit by reference to the reasonable expectancy of renewal for the pool. The proposed regulations provide that, if less than 20 percent of the rights or benefits in the pool are reasonably expected to be renewed, the taxpayer need not capitalize any costs for the rights or benefits in the pool. On the other hand, if more than 80 percent of the rights or benefits in the pool are reasonably expected to be renewed, the taxpayer must capitalize all costs (other than *de minimis* costs described in Parts IV.E. and V.D.2. of this preamble) for the rights or benefits in the pool. If 20 percent or more but 80 percent or less of the rights or benefits in the pool are reasonably expected to be renewed, the taxpayer must capitalize a percentage of costs corresponding to the percentage of rights or benefits in the pool that are reasonably expected to be renewed. The proposed regulations provide that taxpayers may define a pool of similar contracts for this purpose using any reasonable method. A reasonable method would include a definition of a pool based on the type of customer and the type of property or service provided.

The IRS and Treasury Department stress that the pooling methods outlined in these proposed regulations are not effective unless these pooling methods are ultimately promulgated in final regulations. Accordingly, these proposed regulations do not provide authority for taxpayers to adopt the pooling methods outlined herein. Public comments are requested regarding the following specific issues related to pooling (both with respect to pools established for purposes of applying the 12-month rule and with respect to pools established for purposes of applying the *de minimis* rules):

(a) Would pooling be a useful simplification measure for taxpayers?

(b) Should a pooling method be provided in final regulations, or are rules governing pooling more appropriately issued in the form of industry-specific guidance or other non-regulatory guidance (*e.g.*, revenue procedure)?

(c) Should a pooling method be treated as a method of accounting under section 446?

(d) Should the regulations define what constitutes “similar” contract rights or other rights for purposes of defining a pool? If so, what factors should be considered in determining whether rights are similar?

(e) Should the regulations require the use of the same pools for depreciation purposes as are used for purposes of determining the amount capitalized under the regulations? Is additional guidance necessary to clarify the interaction of the pooling rules with the rules in section 167 and § 1.167(a)–8?

(f) The IRS and Treasury Department intend to require a minimum number of similar transactions that a taxpayer must engage in during a taxable year in order to be eligible to apply the pooling method. Comments are requested regarding what this minimum number of similar transactions should be.

VII. Safe Harbor Amortization

A. In general

The proposed regulations amend § 1.167(a)–3 to provide a 15-year safe harbor amortization period for certain created or enhanced intangibles that do not have readily ascertainable useful lives. For example, amounts paid to obtain certain memberships or privileges of indefinite duration would be eligible for the safe harbor amortization provision. Under the safe harbor, amortization is determined using a straight-line method with no salvage value.

The prescribed 15-year period is consistent with the amortization period prescribed by section 197. Many commentators suggested that any safe harbor amortization period should be no longer than 60 months, and noted that a 60-month amortization period is consistent with amortization periods prescribed by sections 195 (start up expenditures), 248 (organizational expenditures), and 709 (partnership organization and syndication fees) of the Code. The IRS and Treasury Department are concerned that an amortization period shorter than 15 years would create tension with sec-

tion 197, and might encourage attempts to circumvent the provisions of section 197.

The safe harbor amortization period does not apply to intangibles acquired from another party or to created financial interests. These intangibles are generally not amortizable, are amortizable under section 197, or are amortizable over a period prescribed by other provisions of the Code or regulations.

The safe harbor amortization period also does not apply to created intangibles that have readily ascertainable useful lives on which amortization can be based. Existing law permits taxpayers to amortize intangible assets with reasonably estimable useful lives. § 1.167(a)-3. For instance, prepaid expenses, contracts with a fixed duration, and certain contract terminations have readily ascertainable useful lives on which amortization can be based. Prepaid expenses are amortized over the period covered by the prepayment. Amounts paid to induce another to enter into a contract with a fixed duration are amortized over the duration of the contract. Amounts paid by a lessor to terminate a lease contract are amortized over the remaining term of the lease. *Peerless Weighing and Vending Machine Corp. v. Commissioner*, 52 T.C. 850, 852 (1969).

The safe harbor amortization period does not overrule existing amortization periods prescribed or prohibited by the Code, regulations, or other guidance. See, e.g., section 167(f)(1)(A) (prescribing a 36-month life for certain computer software); 171 (prescribing rules for determining the amortization period for bond premium); 178 (prescribing the amortization period for costs to acquire a lease); 197 (prescribing a 15-year life for certain intangible assets); § 1.167(a)-14(d)(1) (prescribing a 108-month useful life for mortgage servicing rights).

Finally, the 15-year safe harbor does not apply to amounts paid in connection with real property owned by another. As discussed in Part IV.G. of this preamble, the proposed regulations provide a 25-year safe harbor amortization period for those amounts.

B. Restructurings, reorganizations and transactions involving the acquisition of capital

The proposed regulations do not provide safe harbor amortization for capital-

ized transaction costs that facilitate a stock issuance or other transaction involving the acquisition of capital. The regulations maintain the historical treatment of stock issuance costs and costs that facilitate a recapitalization. Historically, such costs have been treated as a reduction of capital proceeds from the transaction, and not as a separate intangible asset that is amortizable over a useful life. See Rev. Rul. 69-330, 1969-1 C.B. 51; *Affiliated Capital Corp. v. Commissioner*, 88 T.C. 1157 (1987).

In addition, the proposed regulations do not allow safe harbor amortization for capitalized transaction costs that facilitate a restructuring or reorganization of a business entity. As discussed below, comments are requested regarding the appropriateness of applying the safe harbor amortization period to certain of these costs.

1. Acquirer's Costs in a Taxable Acquisition

The safe harbor amortization provisions do not apply to transaction costs properly capitalized by an acquirer to facilitate the acquisition of the stock or assets of a target corporation in a taxable acquisition. In such a case, existing law provides that transaction costs are properly capitalized to the basis of the stock or assets acquired. See *Woodward v. Commissioner*, 397 U.S. 572 (1970). In the case of a stock acquisition, the capitalized transaction costs are not amortizable, but offset any subsequent gain or loss realized on the disposition of the stock. In the case of an asset acquisition, the capitalized transaction costs generally may be recovered as part of the recovery of the basis of the assets.

2. Target's Costs in a Taxable Acquisition

The safe harbor amortization rules also do not apply to transaction costs incurred by a target to facilitate the acquisition of its assets by an acquirer in a taxable transaction. In such a case, the transaction costs generally are an offset against any gain or loss realized by the target on the disposition of its assets.

While the proposed regulations do not allow safe harbor amortization of transaction costs capitalized by a target to facilitate the acquisition of its stock by an acquirer in a taxable transaction, the IRS

and Treasury Department request comments on whether safe harbor amortization should be allowed in such a transaction. Existing law provides no useful life for these capitalized costs, and little guidance concerning when taxpayers may recover these costs. See, e.g., *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (indicating that where no specific asset or useful life can be ascertained, a capitalized cost is deducted upon dissolution of the enterprise). The IRS and Treasury Department believe that the application of a safe harbor amortization period to such costs might help to eliminate much of the current controversy that exists concerning the proper treatment of these costs.

3. Acquirer's and Target's Costs in a Tax-Free Acquisition

In determining whether the safe harbor amortization provision should apply to transaction costs that facilitate a tax-free acquisition, threshold issues exist regarding the proper treatment of capitalized costs. Comments are requested concerning the following issues:

(a) 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?

(b) 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?

(c) 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?

(d) 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?

(e) 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)?

4. Costs to Facilitate a Borrowing

Existing law requires that capitalized transaction costs incurred to borrow money (debt issuance costs) be deducted over the term of the debt. For example, see *Enoch v. Commissioner*, 57 T.C. 781 (1972). The regulations do not propose to change this treatment. Accordingly, the safe harbor amortization provision does not apply to capitalized debt issuance costs. However, in order to conform the rules for debt issuance costs with the rules for original issue discount, the proposed regulations generally require the use of a constant yield method to determine how much of these costs are deductible each year by the borrower. See proposed § 1.446-5.

VIII. Computer Software Issues

The ANPRM requested public comment on the rules and principles that should apply in distinguishing acquired software from developed software. Under existing law, costs to acquire software are appropriately capitalized and may be amortized over 36 months or, in some cases, 15 years. Sections 167(f) and 197(d)(1)(C)(iii). Costs to develop software, on the other hand, may be deducted as incurred in accordance with Rev. Proc. 2000-50, 2000-2 C.B. 601.

The determination of whether software is developed or acquired is a factual inquiry that depends on an analysis of the activities performed by the various parties to the software transaction. While a few commentators identified factors that help to distinguish acquired software from developed software, commentators also suggested that

this issue should be addressed in separate guidance, and not in the proposed regulations.

The IRS and Treasury Department agree that the determination of whether computer software is acquired or developed raises issues that are beyond the scope of these proposed regulations. Accordingly, the proposed regulations do not provide rules for distinguishing acquired software from developed software. These issues will be addressed in subsequent guidance.

Many commentators suggested that the proposed regulations should provide guidance concerning the treatment of costs to implement acquired software. For example, commentators noted that issues often arise regarding the extent to which section 263(a) requires capitalization of costs to implement Enterprise Resource Planning (ERP) software. ERP software is an enterprise-wide database software system that integrates business functions such as financial accounting, sales and distribution, materials management, and production planning. Implementation of an ERP system may take several years and generally involves various categories of costs, including (1) costs to acquire the ERP software package from the vendor, (2) costs to install the acquired ERP software on the taxpayer's computer hardware and to configure the software to the taxpayer's needs through the use of the options and templates embedded in the software, (3) software development costs, and (4) costs to train employees in the use of the new software.

The proposed regulations do not specifically address the treatment of ERP software. However, the IRS and Treasury Department expect that the final regulations will address these costs and, subject to the simplifying conventions provided in the regulations for employee compensation, overhead, and *de minimis* transaction costs, will treat such costs in a manner consistent with the treatment prescribed in Private Letter Ruling 200236028 (June 4, 2002) (available in the IRS Freedom of Information Act Reading Room, 1111 Constitution Avenue, NW, Washington, DC 20224). The IRS and Treasury Department request comments on the treatment of ERP implementation costs under the principles contained in these proposed regulations.

IX. Proposed Effective Date

These regulations are proposed to be applicable on the date on which the final regulations are published in the **Federal Register**. The regulations provide rules applicable to taxpayers that seek to change a method of accounting to comply with the rules contained in the final regulations. Taxpayers may not change a method of accounting in reliance upon the rules contained in these proposed regulations until the rules are published as final regulations in the **Federal Register**.

Upon publication of the final regulations, taxpayers must follow the applicable procedures for obtaining the Commissioner's automatic consent to a change in accounting method. The proposed regulations provide that any change in a method of accounting is made using an adjustment under section 481(a), but that such adjustment is determined by taking into account only amounts paid or incurred on or after the date the final regulations are published in the **Federal Register**.

The IRS and Treasury Department are concerned about the potential administrative burden on taxpayers and the IRS that may result from a section 481(a) adjustment that takes into account amounts paid or incurred prior to the effective date of the regulations. Given the potential for section 481(a) adjustments that originate many years prior to the effective date of the regulations, the IRS and Treasury Department question whether adequate documentation is available to compute the adjustment with reasonable accuracy.

The IRS and Treasury Department request comments on whether there are circumstances in which it is appropriate to permit a change in method of accounting to be made using an adjustment under section 481(a) that takes into account amounts paid or incurred prior to the effective date of the regulations. If there are such circumstances, comments are requested on the appropriate number of taxable years prior to the effective date of the regulations that taxpayers should be permitted to look back for purposes of computing the adjustment. Finally, the IRS and Treasury Department request comments on any additional terms and conditions for changes in methods of accounting that would be helpful to taxpayers in adopting the rules contained in these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 22, 2003, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 1, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the dead-

line for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Andrew J. Keyso of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART I — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.167(a)–3 is amended by:

1. Adding a paragraph designation and heading to the undesignated paragraph.
2. Adding paragraph (b).

The additions read as follows:

§ 1.167(a)–3 *Intangibles.*

(a) In general. * * *

(b) *Safe harbor amortization for certain intangible assets* — (1) *Amortization period.* For purposes of determining the depreciation allowance referred to in paragraph (a) of this section, a taxpayer may treat an intangible asset as having a useful life equal to 15 years unless —

(i) An amortization period for the intangible asset is specifically prescribed or prohibited by the Internal Revenue Code, regulations, or other published guidance;

(ii) The intangible asset is described in § 1.263(a)–4(c) (relating to intangibles acquired from another person) or § 1.263(a)–4(d)(2) (relating to created financial interests);

(iii) The intangible asset has a useful life that is readily ascertainable; or

(iv) The intangible asset is described in § 1.263(a)–4(d)(8) (relating to certain benefits arising from the provision, production, or improvement of real property), in which case the taxpayer may treat the intangible asset as having a useful life equal to 25 years.

(2) *Applicability to restructurings, reorganizations, and acquisitions of capital.* The safe harbor amortization period provided by paragraph (b)(1) of this section does not apply to an amount required to be capitalized by § 1.263(a)–4(b)(1)(iii) (relating to amounts paid to facilitate a restructuring, reorganization or transaction involving the acquisition of capital).

(3) *Depreciation method.* A taxpayer that determines its depreciation allowance for an intangible asset using the 15-year amortization period prescribed by paragraph (b)(1) of this section (or the 25-year amortization period in the case of an intangible asset described in § 1.263(a)–4(d)(8)) must determine the allowance by amortizing the basis of the intangible asset (as determined under section 167(c) and without regard to salvage value) ratably over the amortization period beginning on the first day of the month in which the intangible asset is placed in service by the taxpayer. The intangible asset is not eligible for amortization in the month of disposition.

Par. 3. Section 1.263(a)–4 is added to read as follows:

§ 1.263(a)–4 *Amounts paid to acquire, create, or enhance intangible assets.*

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire, create, or enhance intangible assets. Except to the extent provided in paragraph (d)(8) of this section, the rules provided by this section do not apply to amounts paid to acquire, create, or enhance tangible assets. Paragraph (b) of this section provides a general principle of capitalization. Paragraphs (c) and (d) of this section identify intangibles for which capitalization is specifically required under the general principle. Paragraph (e) of this section provides rules for determining the extent to which taxpayers must capitalize transaction costs. Paragraph (f) of this section provides a 12-month rule intended to simplify the application of the general principle to certain payments that create benefits of a brief duration. Additional rules and examples relating to these provisions are provided in paragraphs (g) through (n) of this section. The applicability date of the rules in this section is provided in paragraph (o) of this section.

(b) *Capitalization of intangible assets* — (1) *In general.* Except as otherwise provided in chapter 1 of the Internal Revenue Code, a taxpayer must capitalize —

(i) An amount paid to acquire, create, or enhance an intangible asset (within the meaning of paragraph (b)(2) of this section);

(ii) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) the acquisition, creation, or enhancement of an intangible asset; and

(iii) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.

(2) *Intangible asset* — (i) *In general*. For purposes of this section, the term *intangible asset* means —

(A) An intangible described in paragraph (c) of this section (relating to acquired intangibles);

(B) An intangible described in paragraph (d) of this section (relating to certain created or enhanced intangibles);

(C) A separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section; or

(D) A future benefit identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as an intangible asset for which capitalization is required under this section.

(ii) *Published guidance*. Any published guidance identifying a future benefit as an intangible asset for which capitalization is required under paragraph (b)(2)(i)(D) of this section applies only to amounts paid on or after the date of publication of the guidance.

(3) *Separate and distinct intangible asset* — (i) *Definition*. The term *separate and distinct intangible asset* means a property interest of ascertainable and measurable value in 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). The determination of whether an amount is paid to acquire, create, or enhance a separate and distinct intangible asset is made as of the taxable year during which the payment is made.

(ii) *Creation or termination of contract rights*. Amounts paid to another party to create or originate an agreement with that party that produces rights or benefits for the tax-

payer do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). Further, amounts paid to another party to terminate an agreement with that party do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). See paragraphs (d)(2), (6) and (7) of this section for rules that specifically require capitalization of amounts paid to create or terminate certain agreements. See paragraph (e)(1)(ii) of this section for rules relating to the treatment of certain termination payments that facilitate another transaction for which capitalization is required under this section.

(c) *Acquired intangibles* — (1) *In general*. A taxpayer must capitalize amounts paid to another party to acquire an intangible from that party in a purchase or similar transaction. Intangibles within the scope of this paragraph (c) include, but are not limited to, the following (if acquired from another party in a purchase or similar transaction):

(i) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other similar entity.

(ii) A debt instrument, 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.

(iii) A financial instrument, including, but not limited to —

(A) A letter of credit;

(B) A credit card agreement;

(C) A notional principal contract;

(D) A foreign currency contract;

(E) A futures contract;

(F) A 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));

(G) An 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

(H) Any other financial derivative.

(iv) An endowment contract, annuity contract, or insurance contract that has or may have cash value.

(v) Non-functional currency.

(vi) A lease contract.

(vii) A patent or copyright.

(viii) A franchise, trademark or trade-name (as defined in § 1.197-2(b)(10)).

(ix) An assembled workforce (as defined in § 1.197-2(b)(3)).

(x) Goodwill (as defined in § 1.197-2(b)(1)) or going concern value (as defined in § 1.197-2(b)(2)).

(xi) A customer list.

(xii) A servicing right (for example, a mortgage servicing right).

(xiii) A customer-based intangible (as defined in § 1.197-2(b)(6)) or supplier-based intangible (as defined in § 1.197-2(b)(7)).

(xiv) Computer software.

(2) *Readily available software*. An amount paid to obtain 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 § 1.197-2(c)(4)) is treated for purposes of this paragraph (c) as an amount paid to another party to acquire an intangible from that party in a purchase or similar transaction.

(3) *Intangibles acquired from an employee*. Amounts paid to an employee to acquire an intangible from that employee are not required to be capitalized under this section if the amounts are treated as compensation for personal services includible in the employee's income under section 61 or 83. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(4) *Examples*. The following examples illustrate the rules of this paragraph (c):

Example 1. Financial instrument. X corporation, a commercial bank, purchases a portfolio of existing loans from Y corporation, another financial institution. X pays Y \$2,000,000 in exchange for the portfolio. The \$2,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation holds a call option entitling it to purchase from W all of the outstanding stock of X at a certain price per share. Z corporation acquires the call option from Y in exchange for \$5,000,000. The \$5,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 3. Ownership interest in a corporation. Same as *Example 2*, but assume Z exercises its option and purchases from W all of the outstanding stock of X in exchange for \$100,000,000. The \$100,000,000 paid to W constitutes an amount paid to acquire an intangible from W and must be capitalized.

Example 4. Customer list. N corporation, a retailer, sells its products exclusively through its catalog and mail order system. N purchases a customer

list from R corporation. N pays R \$100,000 in exchange for the customer list. The \$100,000 paid to R constitutes an amount paid to acquire an intangible from R and must be capitalized.

Example 5. Lease. V corporation seeks to lease commercial property in a prominent downtown location of city R. V identifies desirable property in city R that is currently under lease by X corporation to W corporation under a 10-year assignable lease. V pays W \$50,000 to acquire the lease and relocates its operations from city O to city R. The \$50,000 paid to W constitutes an amount paid to W to acquire an intangible from W and must be capitalized.

Example 6. Goodwill. Z corporation pays W corporation \$10,000,000 to purchase all of the assets of W in a transaction that constitutes an applicable asset acquisition under section 1060(c). Of the \$10,000,000 consideration paid in the transaction, \$9,000,000 is allocable to tangible assets purchased from W and \$1,000,000 is allocable to goodwill. The \$1,000,000 allocable to goodwill constitutes an amount paid to W to acquire intangibles from W and must be capitalized.

(d) *Created intangibles* — (1) *In general.* Except as provided in paragraph (f) of this section (relating to the 12-month rule), a taxpayer must capitalize amounts paid to create or enhance an intangible described in this paragraph (d).

(2) *Financial interests* — (i) *In general.* A taxpayer must capitalize amounts paid to another party to create or originate with that party any of the following financial interests, whether or not the interest is regularly traded on an established market:

(A) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other similar entity.

(B) A debt instrument, 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.

(C) A financial instrument, including, but not limited to —

- (1) A letter of credit;
- (2) A credit card agreement;
- (3) A notional principal contract;
- (4) A foreign currency contract;
- (5) A futures contract;

(6) A 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));

(7) An 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

- (8) Any other financial derivative.

(D) An endowment contract, annuity contract, or insurance contract that has or may have cash value.

(E) Non-functional currency.

(ii) *Exception for current and prior sales.* An amount is not required to be capitalized under paragraph (d)(2)(i)(C)(6) or (7) of this section 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.

(iii) *Coordination with other provisions of this paragraph (d).* An amount described in this paragraph (d)(2) that is also described elsewhere in paragraph (d) of this section is treated as described only in this paragraph (d)(2).

(iv) *Examples.* The following examples illustrate the rules of this paragraph (d)(2):

Example 1. Loan. X corporation, a commercial bank, makes a loan to A in the principal amount of \$250,000. Under paragraph (d)(2)(i)(B) of this section, the \$250,000 principal amount of the loan paid to A constitutes an amount paid to another party to create a financial instrument with that party and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation pays W \$1,000,000 in exchange for W's grant of a 3-year call option to Y permitting Y to purchase all of the outstanding stock of X at a certain price per share. Under paragraph (d)(2)(i)(C)(7) of this section, Y's payment of \$1,000,000 to W constitutes an amount paid to another party to create or originate an option with that party and must be capitalized.

Example 3. Partnership interest. Z corporation pays \$10,000 to P, a partnership, in exchange for an ownership interest in P. Under paragraph (d)(2)(i)(A) of this section, Z's payment of \$10,000 to P constitutes an amount paid to another party to create an ownership interest in a partnership with that party and must be capitalized.

Example 4. Take or pay contract. Q corporation, a producer of natural gas, pays \$1,000,000 to R during 2002 to induce R corporation to enter into a 5-year "take or pay" gas purchase contract. Under the contract, R is liable to pay for a specified minimum amount of gas, whether or not R takes such gas. Under paragraph (d)(2)(i)(C)(6) of this section, Q's payment is an amount paid to another party to induce that party to enter into an agreement providing Q the right and obligation to provide property or be compensated for such property, regardless of whether the property is provided. Because the agreement does not require that the property be provided prior to the end of the taxable year in which the amount is paid, Q must capitalize the entire \$1,000,000 paid to R.

Example 5. Agreement to provide property. P corporation pays R corporation \$1,000,000 in exchange for R's agreement to purchase 1,000 units of P's product at any time within the three succeeding calendar years. The agreement describes P's \$1,000,000 as a sales discount. Under paragraph (d)(2)(i)(C)(6) of this section, P's \$1,000,000 payment is an amount paid to induce R to enter into an agreement providing P the

right and obligation to provide property. Because the agreement does not require that the property be provided prior to the end of the taxable year in which the amount is paid, P must capitalize the entire \$1,000,000 payment.

Example 6. Customer incentive payment. S corporation, a computer manufacturer, seeks to develop a business relationship with V corporation, a computer retailer. As an incentive to encourage V to purchase computers from S, S enters into an agreement with V under which S agrees that, if V purchases \$20,000,000 of computers from S within 3 years from the date of the agreement, S will pay V \$2,000,000 on the date that V reaches the \$20,000,000 threshold. V reaches the \$20,000,000 threshold during the third year of the agreement, and S pays V \$2,000,000. S is not required to capitalize its payment to V under this paragraph (d)(2) because the payment does not provide S the right to provide property. Moreover, the agreement between S and V requires that the computers be provided prior to the end of the taxable year in which the \$2,000,000 is paid. In addition, as provided in paragraph (b)(3)(ii) of this section, S's \$2,000,000 payment does not create or enhance a separate and distinct intangible asset for S within the meaning of paragraph (b)(3)(i) of this section.

Example 7. Sales discount. P corporation, a sofa manufacturer that uses the calendar year for federal income tax purposes, seeks to develop a business relationship with R corporation, a furniture retailer. In 2002, P enters into a 5-year agreement with R under which P agrees to reimburse 10 percent of the purchase price paid by R if R purchases more than 1,000 sofas in a single order. In addition, under the agreement, R agrees to purchase 2,000 sofas from P in a single order for delivery during 2002. At the time the agreement is executed, P pays R \$20,000, reflecting the 10 percent discount on the first 2,000 sofas to be purchased by R during 2002. The \$20,000 payment provides P the right and obligation to provide property (2,000 sofas). Nevertheless, because the agreement requires that the sofas be provided prior to the end of the taxable year in which the amount is paid, P is not required to capitalize its \$20,000 payment under this paragraph (d)(2). In addition, as provided in paragraph (b)(3)(ii) of this section, P's \$20,000 payment does not create or enhance a separate and distinct intangible asset for P within the meaning of paragraph (b)(3)(i) of this section.

(3) *Prepaid expenses* — (i) *In general.* A taxpayer must capitalize amounts prepaid for benefits to be received in the future.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(3):

Example 1. Prepaid insurance. N corporation, an accrual method taxpayer, pays \$10,000 to an insurer to obtain an insurance policy with a 3-year term. The \$10,000 is an amount prepaid by N for benefits to be received in the future and must be capitalized under this paragraph (d)(3).

Example 2. Prepaid rent. X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, X pre-pays \$240,000. No other amounts are due under the lease. The \$240,000 is an amount prepaid by X for benefits to be received in the future and must be capitalized under this paragraph (d)(3).

(4) *Certain memberships and privileges*

— (i) *In general.* A taxpayer must capitalize amounts paid to an organization to obtain or renew a membership or privilege from that organization. A taxpayer is not required to capitalize under this paragraph (d)(4) an amount paid to obtain certification of the taxpayer's products, services, or business processes.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(4):

Example 1. Hospital privilege. B, a physician, pays \$10,000 to Y corporation to obtain lifetime staff privileges at a hospital operated by Y. B must capitalize the \$10,000 payment under this paragraph (d)(4).

Example 2. Initiation fee. X corporation pays a \$50,000 initiation fee to obtain membership in a social club. X must capitalize the \$50,000 payment under this paragraph (d)(4).

Example 3. Product rating. V corporation, an automobile manufacturer, pays W corporation, a national quality ratings association, \$100,000 to conduct a study and provide a rating of the quality and safety of a line of V's automobiles. V's payment is an amount paid to obtain a certification of V's product and is not required to be capitalized under this paragraph (d)(4).

Example 4. Business process certification. Z corporation, a manufacturer, seeks to obtain a certification that its quality control standards meet a series of international standards known as ISO 9000. Z pays \$50,000 to an independent registrar to obtain a certification from the registrar that Z's quality management system conforms to the ISO 9000 standard. Z's payment is an amount paid to obtain a certification of Z's business processes and is not required to be capitalized under this paragraph (d)(4).

(5) *Certain rights obtained from a governmental agency* — (i) *In general.* A taxpayer must capitalize amounts paid to a governmental agency to obtain or renew a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(5):

Example 1. Business license. X corporation pays \$15,000 to state Y to obtain a business license that is valid indefinitely. Under this paragraph (d)(5), the amount paid to state Y is an amount paid to a government agency for a right granted by that agency. Accordingly, X must capitalize the \$15,000 payment.

Example 2. Bar admission. A, an individual, pays \$1,000 to an agency of state Z to obtain a license to practice law in state Z that is valid indefinitely, provided A adheres to the requirements governing the practice of law in state Z. Under this paragraph (d)(5), the amount paid to state Z is an amount paid to a government agency for a right granted by that agency. Accordingly, A must capitalize the \$1,000 payment.

(6) *Certain contract rights* — (i) *In general.* Except as otherwise provided in this paragraph (d)(6), a taxpayer must capitalize amounts paid to another party to induce that party to enter into, renew, or renegotiate —

(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 acquire services (or the right to be compensated for such services); or

(C) A covenant not to compete or an agreement having substantially the same effect as a covenant not to compete (except, in the case of an agreement that requires the performance of services, to the extent that the amount represents reasonable compensation for services actually rendered).

(ii) *De minimis amounts.* A taxpayer is not required to capitalize amounts paid to another party (or parties) to induce that party (or those parties) to enter into, renew, or renegotiate an agreement described in paragraph (d)(6)(i) of this section if the aggregate of all amounts paid to that party (or those parties) with respect to the agreement does not exceed \$5,000. If the aggregate of all amounts paid to the other party (or parties) with respect to that agreement exceeds \$5,000, then all amounts must be capitalized. In general, a taxpayer must determine whether the rules of this paragraph (d)(6)(ii) apply by accounting for the amounts paid with respect to each agreement. However, a taxpayer may elect to establish one or more pools of agreements for purposes of determining the amounts paid with respect to an agreement. Under this pooling method, the amounts paid with respect to each agreement included in the pool is equal to the average amount paid with respect to all agreements included in the pool. A taxpayer computes the average amount paid with respect to all agreements included in the pool by dividing the sum of all amounts paid with respect to all agreements included in the pool by the number of agreements included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(iii) *Exceptions* — (A) *Current and prior sales.* An amount is not required to be capitalized under paragraph (d)(6)(i)(B) of this section 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.

(B) *Lessee construction allowances.* Paragraph (d)(6)(i) of this section does not

apply to amounts paid by a lessor to a lessee as a construction allowance for tangible property (see, for example, section 110).

(iv) *Examples.* The following examples illustrate the rules of this paragraph (d)(6):

Example 1. New lease agreement. V seeks to lease commercial property in a prominent downtown location of city R. V pays the owner of the commercial property \$50,000 as an inducement to enter into a 10-year lease with V. V's payment is an amount paid to another party to induce that party to enter into an agreement providing V the right to use tangible property. Because the \$50,000 payment exceeds \$5,000, no portion of the amount paid to Z is *de minimis* for purposes of paragraph (d)(6)(ii) of this section. Under paragraph (d)(6)(i)(A) of this section, V must capitalize the entire \$50,000 payment.

Example 2. Modification of lease agreement. Partnership Y leases a piece of equipment for use in its business from Z corporation. When the lease has a remaining term of 3 years, Y requests that Z modify the lease by extending the remaining term by 5 years. Y pays \$50,000 to Z in exchange for Z's agreement to modify the existing lease. Y's payment of \$50,000 is an amount paid to induce Z to renegotiate an agreement providing Y the right to use property. Because the \$50,000 payment exceeds \$5,000, no portion of the amount paid to Z is *de minimis* for purposes of paragraph (d)(6)(ii) of this section. Under paragraph (d)(6)(i)(A) of this section, Y must capitalize the entire \$50,000 paid to induce Z to renegotiate the lease.

Example 3. Covenant not to compete. R corporation enters into an agreement with A, an individual, that prohibits A from competing with R for a period of three years. To encourage A to enter into the agreement, R agrees to pay A \$100,000 upon the signing of the agreement. R's payment is an amount paid to another party to induce that party to enter into a covenant not to compete. Because the \$100,000 payment exceeds \$5,000, no portion of the amount paid to A is *de minimis* for purposes of paragraph (d)(6)(ii) of this section. Under paragraph (d)(6)(i)(C) of this section, R must capitalize the entire \$100,000 paid to A to induce A to enter into the covenant not to compete.

Example 4. De minimis payments. X corporation is engaged in the business of providing wireless telecommunications services to customers. To induce customer B to enter into a 3-year telecommunications contract, X provides B with a free wireless telephone. X pays \$300 to purchase the wireless telephone. X's provision of a wireless telephone to B is an amount paid to B to induce B to enter into an agreement providing X the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Because the amount of the inducement is \$300, the amount of the inducement is *de minimis* under paragraph (d)(6)(ii) of this section. Accordingly, X is not required to capitalize the amount of the inducement provided to B.

(7) *Certain contract terminations* — (i) *In general.* A taxpayer must capitalize amounts paid to another party to terminate —

(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; or

(C) An agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(7):

Example 1. Termination of exclusive license agreement. On July 1, 2001, N enters into a license agreement with R corporation under which N grants R the exclusive right to manufacture and distribute goods using N's design and trademarks for a period of 10 years. On June 30, 2003, N pays R \$5,000,000 in exchange for R's agreement to terminate the exclusive license agreement. N's payment to terminate its license agreement with R constitutes a payment to terminate an exclusive license to use the taxpayer's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, N must capitalize its \$5,000,000 payment to R.

Example 2. Termination of exclusive distribution agreement. On March 1, 2001, L, a manufacturer, enters into an agreement with M granting M the right to be the sole distributor of L's products in state X for 10 years. On July 1, 2004, L pays M \$50,000 in exchange for M's agreement to terminate the distribution agreement. L's payment to terminate its agreement with M constitutes a payment to terminate an exclusive right to acquire L's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, L must capitalize its \$50,000 payment to M.

Example 3. Termination of covenant not to compete. On February 1, 2001, Y corporation enters into a covenant not to compete with Z corporation that prohibits Y from competing with Z in city V for a period of 5 years. On January 31, 2003, Y pays Z \$1,000,000 in exchange for Z's agreement to terminate the covenant not to compete. Y's payment to terminate the covenant not to compete with Z constitutes a payment to terminate an agreement that prohibits Y from competing with Z, as described in paragraph (d)(7)(i)(C) of this section. Accordingly, Y must capitalize its \$1,000,000 payment to Z.

Example 4. Termination of exclusive right to acquire property. W corporation owns one-half of the outstanding stock of X corporation. On July 1, 2002, W grants Y corporation a 5-year call option that permits Y to purchase all of W's stock in X. On June 30, 2004, W pays Y \$50,000 to terminate the option. W's payment to terminate the option with Y constitutes a payment to terminate an exclusive right to acquire W's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, W must capitalize its \$50,000 payment to Y.

Example 5. Termination of supply contract. During 2000, Q corporation enters into a 10-year agreement with R corporation under which R agrees to fulfill all of Q's requirements for packaging materials and supplies used by Q in the distribution of Q's goods. During 2005, Q determines that its contract with R has become unprofitable for Q and seeks to terminate the contract. Q pays R \$100,000 to terminate the contract. Q's payment to terminate the supply contract with R is a payment to terminate an agreement not described in this paragraph (d)(7). Accordingly,

Q is not required to capitalize the \$100,000 payment to R under this paragraph (d)(7). In addition, as provided in paragraph (b)(3)(ii) of this section, Q's \$1,000,000 payment does not create or enhance a separate and distinct intangible asset for Q within the meaning of paragraph (b)(3)(i) of this section.

Example 6. Termination of merger agreement. N corporation enters into an agreement with U corporation under which N and U agree to merge. Prior to the merger, N decides that its business will be more successful if it does not merge with U. N pays U \$10,000,000 to terminate the agreement. At the time of the payment, N is not under an agreement to merge with any other entity. N's payment to terminate the merger agreement with U is a payment to terminate an agreement not described in this paragraph (d)(7). Accordingly, N is not required to capitalize the \$10,000,000 payment under this paragraph (d)(7). In addition, as provided in paragraph (b)(3)(ii) of this section, N's \$10,000,000 payment does not create or enhance a separate and distinct intangible asset for N within the meaning of paragraph (b)(3)(i) of this section.

(8) *Certain benefits arising from the provision, production, or improvement of real property —* (i) *In general.* A taxpayer must capitalize 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.

(ii) *Exclusions.* A taxpayer is not required to capitalize an amount under paragraph (d)(8)(i) of this section to the extent the payment —

(A) Is part of a transaction involving the sale of the real property by the taxpayer;

(B) Is part of the sale of services by the taxpayer to produce or improve the real property;

(C) Is a payment by the taxpayer for some other property or service provided to the taxpayer; or

(D) Is a payment by the taxpayer to another party to create an intangible described in paragraph (d) of this section (other than in this paragraph (d)(8)).

(iii) *Real property.* For purposes of this paragraph (d)(8), real property 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.

(iv) *Impact fees and dedicated improvements.* Paragraph (d)(8)(i) of this section does not apply to amounts paid to satisfy one-time charges imposed by a state or local government against new development

(or expansion of existing development) to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. In addition, paragraph (d)(8)(i) of this section does not apply to amounts paid for 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. See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in this paragraph (d)(8)(iv).

(v) *Examples.* The following examples illustrate the rules of this paragraph (d)(8):

Example 1. Amount paid to produce real property owned by another. W corporation operates a quarry on the east side of a river in city Z and a crusher on the west side of the river. City Z's existing bridges are of insufficient capacity to be traveled by trucks in transferring stone from W's quarry to its crusher. As a result, the efficiency of W's operations is greatly reduced. W contributes \$1,000,000 to City Z to defray in part the cost of construction of a publicly owned bridge capable of accommodating W's trucks. W's payment to city Z is an amount paid to produce real property (within the meaning of paragraph (d)(8)(iii) of this section) that can reasonably be expected to produce significant economic benefits for W. Under paragraph (d)(8)(i) of this section, W must capitalize the \$1,000,000 paid to city Z.

Example 2. Dedicated improvements. X corporation is engaged in the development and sale of residential real estate. In connection with a residential real estate project under construction by X in city Z, X is required by city Z to construct ingress and egress roads to and from its project and immediately transfer the roads to city Z for dedication to general public use. The roads will be maintained by city Z. X pays its subcontractor \$100,000 to construct the ingress and egress roads. X's payment is a dedicated improvement within the meaning of paragraph (d)(8)(iv) of this section. Accordingly, X is not required to capitalize the \$100,000 payment under this paragraph (d)(8). See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in paragraph (d)(8)(iv) of this section.

(9) *Defense or perfection of title to intangible property —* (i) *In general.* A taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property where that other party challenges the taxpayer's title to the intangible property.

(ii) *Example.* The following example illustrates the rules of this paragraph (d)(9):

Example. Defense of title. R corporation claims to own an exclusive patent on a particular technology. U corporation brings a lawsuit against R, claiming that

U is the true owner of the patent, and that R stole the technology from U. The sole issue in the suit involves the validity of R's patent. R chooses to settle the suit by paying U \$100,000 in exchange for U's release of all future claim to the patent. R's payment to U is an amount paid to defend or perfect title to intangible property under paragraph (d)(9) of this section and must be capitalized.

(e) *Transaction costs* — (1) *Scope of facilitation* — (i) *In general*. An amount is paid to facilitate a transaction described in paragraph (b)(1)(ii) of this section (an acquisition, creation, or enhancement of an intangible asset) or to facilitate a transaction described in paragraph (b)(1)(iii) of this section (a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital) if the amount is paid in the process of pursuing the transaction. Whether an amount is paid in the process of pursuing a transaction is determined based on all facts and circumstances. The fact that an amount would (or would not) have been paid but-for the transaction is not relevant in determining whether the amount is paid to facilitate the transaction.

(ii) *Treatment of termination payments in integrated transactions*. An amount paid to terminate (or facilitate the termination of) an existing agreement constitutes an amount paid to facilitate a transaction referred to in paragraph (e)(1)(i) of this section if the transaction is expressly conditioned on the termination of the existing agreement.

(iii) *Ordering rules*. An amount required to be capitalized under paragraph (b)(1)(i) of this section does not facilitate a transaction referred to in paragraph (e)(1)(i) of this section. In addition, an amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing) referred to in paragraph (e)(1)(i) of this section.

(2) *Transaction*. For purposes of this section, the term *transaction* means all of the factual elements comprising an acquisition, creation, or enhancement of an intangible asset (or a restructuring, reorganization, or transaction involving the acquisition of capital) and includes a series of steps carried out as part of a single plan. Thus, a transaction can involve more than one invoice and more than one intangible asset. For example, a purchase of intangible assets under one purchase agreement may constitute a single transaction, notwithstanding the fact that the acquisition involves multiple intangible assets and

the amounts paid to facilitate the acquisition are capable of being allocated among the various intangible assets acquired.

(3) *Simplifying conventions* — (i) *In general*. For purposes of this paragraph (e), compensation paid to employees (including bonuses and commissions paid to employees), overhead, and *de minimis* costs (within the meaning of paragraph (e)(3)(ii) of this section) are treated as amounts that do not facilitate a transaction referred to in paragraph (e)(1)(i) of this section. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(ii) *De minimis costs* — (A) *In general*. Except as provided in paragraph (e)(3)(ii)(B) of this section, the term *de minimis costs* means amounts referred to in paragraph (e)(1)(i) of this section that are paid with respect to a transaction if, in the aggregate, the amounts do not exceed \$5,000. If the amounts exceed \$5,000, no portion of the amounts is a *de minimis* cost within the meaning of this paragraph (e)(3)(ii)(A). In determining the amount of transaction costs paid with respect to a transaction, a taxpayer generally must account for the actual costs paid with respect to the transaction. However, a taxpayer may elect to determine the amount of transaction costs paid with respect to a transaction using the average cost pooling method described in paragraph (e)(3)(ii)(C) of this section.

(B) *Treatment of commissions*. The term *de minimis costs* does not include commissions paid to facilitate the acquisition of an intangible described in paragraphs (c)(1)(i) through (v) of this section or to facilitate the creation or origination of an intangible described in paragraphs (d)(2)(i)(A) through (E) of this section.

(C) *Average cost pooling method*. A taxpayer may elect to establish one or more pools of similar transactions for purposes of determining the amount of transaction costs paid with respect to a transaction. Under this pooling method, the amount of transaction costs paid with respect to each transaction included in the pool is equal to the average transaction costs paid with respect to all transactions included in the pool. A taxpayer computes the average transaction costs paid with respect to all transactions included in the pool by dividing the sum of all transaction costs paid with re-

spect to all transactions included in the pool by the number of transactions included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(4) *Special rules applicable to certain trade or business acquisition and reorganization transactions* — (i) *Acquisitive transactions* — (A) *In general*. Except as provided in paragraph (e)(4)(i)(B) of this section, in the case of an acquisition of a trade or business (whether structured as an acquisition of stock or of assets and whether the taxpayer is the acquirer in the acquisition or the target of the acquisition), an amount paid in the process of pursuing the acquisition facilitates the acquisition within the meaning of this paragraph (e) only if the amount relates to activities performed on or after the earlier of —

(1) The date on which the acquirer submits to the target a letter of intent, offer letter, or similar written communication proposing a merger, acquisition, or other business combination; or

(2) The date on which an acquisition proposal is 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 acquisition proposal is approved by the appropriate governing officials of the taxpayer.

(B) *Inherently facilitative amounts*. An amount paid in the process of pursuing an acquisition facilitates that acquisition if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined under paragraph (e)(4)(i)(A) of this section. An amount is inherently facilitative if the amount is paid for activities performed in determining the value of the target, negotiating or structuring the transaction, preparing and reviewing transactional documents, preparing and reviewing regulatory filings required by the transaction, obtaining regulatory approval of the transaction, securing advice on the tax consequences of the transaction, securing an opinion as to the fairness of the transaction, obtaining shareholder approval of the transaction, or conveying property between the parties to the transaction.

(C) *Success-based fees*. An amount paid that is contingent on the successful closing of an acquisition is an amount paid to facilitate the acquisition except to the ex-

tent that evidence clearly demonstrates that some portion of the amount is allocable to activities that do not facilitate the acquisition.

(D) *Integration costs.* An amount paid to integrate the business operations of the acquirer and the target does not facilitate the acquisition within the meaning of paragraph (e)(1)(i) of this section, regardless of when the integration activities occur.

(ii) *Divisive transactions* — (A) *Stock distributions.* An amount paid to facilitate a distribution of stock to the shareholders of a taxpayer is not required to be capitalized under this section if the divestiture is required by law, regulatory mandate, or court order unless the divestiture itself facilitates another transaction referred to in paragraph (e)(1)(i) of this section. For example, where a taxpayer, to comply with a new law requiring the taxpayer to divest itself of a particular trade or business, contributes that trade or business to a new subsidiary and distributes the stock of the subsidiary to the taxpayer's shareholders, amounts paid to facilitate the distribution do not facilitate a transaction referred to in paragraph (e)(1)(i) of this section and are not required to be capitalized under this section. Conversely, where a taxpayer, to secure regulatory approval for its proposed acquisition of a target corporation, complies with a government mandate to divest itself of a particular trade or business and contributes the trade or business to a new subsidiary and distributes the stock of the subsidiary to the taxpayer's shareholders, amounts paid to facilitate the divestiture are amounts paid to facilitate the acquisition of the target and must be capitalized under this section.

(B) *Taxable asset sales.* An amount paid to facilitate the sale of assets in a transaction not described in section 368 is not required to be capitalized under this section unless the sale is required by law, regulatory mandate, or court order and the sale itself facilitates another transaction referred to in paragraph (e)(1)(i) of this section. For example, where a target corporation, in preparation for a merger with an acquirer, sells assets that are not desired by the acquirer, amounts paid to facilitate the sale are not required to be capitalized as amounts paid to facilitate the merger. Conversely, where a taxpayer, in order to secure regulatory approval for its proposed acquisition of a target corporation,

complies with a government mandate to divest itself of a particular trade or business and sells the assets of that trade or business in a taxable sale, amounts paid to facilitate the sale are amounts paid to facilitate the acquisition of the target and must be capitalized under this section.

(iii) *Defense against a hostile acquisition attempt* — (A) *In general.* An amount paid to defend against an acquisition of the taxpayer in a hostile acquisition attempt is not an amount paid to facilitate a transaction within the meaning of paragraph (e)(1)(i) of this section. In determining whether an acquisition attempt is hostile, all relevant facts and circumstances are taken into account. The mere fact that the taxpayer receives an unsolicited offer from a potential acquirer, or rejects an initial offer from a potential acquirer, is not determinative of whether an acquisition attempt is hostile. On the other hand, the fact that the taxpayer implements defensive measures in response to the acquisition attempt is evidence that the acquisition attempt is hostile. Once an acquisition attempt ceases to be hostile, an amount paid by the taxpayer in the process of pursuing the acquisition of its stock by the acquirer is an amount paid to facilitate a transaction referred to in paragraph (e)(1)(i) of this section.

(B) *Exception for amounts paid to facilitate another capital transaction.* An amount paid to defend against an acquisition of the taxpayer in a hostile acquisition attempt does not include a payment that, while intended to thwart a hostile acquisition attempt by an acquirer, itself facilitates another transaction referred to in paragraph (e)(1)(i) of this section. Thus, for example, an amount paid to effect a recapitalization in an effort to defend against a hostile acquisition attempt is not an amount paid to defend against an acquisition of the taxpayer in a hostile acquisition attempt for purposes of paragraph (e)(4)(iii)(A) of this section.

(5) *Coordination with paragraph (d) of this section.* In the case of an amount paid to facilitate the creation or enhancement of an intangible described in paragraph (d) of this section, the provisions of this paragraph (e) apply regardless of whether a payment described in paragraph (d) is made.

(6) *Application to stock issuance costs of open-end regulated investment companies.* Amounts paid by an open-end regu-

lated investment company (within the meaning of section 851) to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction referred to in paragraph (e)(1)(i) of this section unless such amounts are paid during the initial stock offering period.

(7) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. Costs to facilitate. In December 2002, R corporation, a calendar year taxpayer, enters into negotiations with X corporation to lease commercial property from X for a period of 25 years. R pays A, its outside legal counsel, \$4,000 in December 2002 for services rendered by A during December in assisting with negotiations with X. In January 2003, R and X finalize the terms of the lease and execute the lease agreement. R pays B, another of its outside legal counsel, \$2,000 in January 2003 for services rendered by B during January in drafting the lease agreement. The agreement between R and X is an agreement providing R the right to use property, as described in paragraph (d)(6)(i)(A) of this section. R's payments to its outside counsel are amounts paid to facilitate the creation of the agreement. As provided in paragraph (e)(3)(ii)(A) of this section, R must aggregate its transaction costs for purposes of determining whether the transaction costs are *de minimis*. Because R's aggregate transaction costs exceed \$5,000, R's transaction costs are not *de minimis* costs within the meaning of paragraph (e)(3)(ii)(A) of this section. Accordingly, R must capitalize the \$4,000 paid to A and the \$2,000 paid to B under paragraph (b)(1)(ii) of this section.

Example 2. Costs to facilitate. Q corporation pays its outside counsel \$20,000 to assist Q in registering its stock with the Securities and Exchange Commission. Q is not a regulated investment company within the meaning of section 851. Q's payments to its outside counsel are amounts paid to facilitate the issuance of stock. Accordingly, Q must capitalize its \$20,000 payment under paragraph (b)(1)(iii) of this section.

Example 3. Costs to facilitate. Partnership X leases its manufacturing equipment from Y corporation under a 10-year lease. During 2002, when the lease has a remaining term of 4 years, X enters into a written agreement with Z corporation, a competitor of Y, under which X agrees to lease its manufacturing equipment from Z, subject to the condition that X first successfully terminates its lease with Y. X pays Y \$50,000 in exchange for Y's agreement to terminate the equipment lease. Because the new lease is expressly conditioned on the termination of the old lease agreement, as provided in paragraph (e)(1)(ii) of this section, X's payment of \$50,000 facilitates the creation of a new lease. Accordingly, X must capitalize the \$50,000 termination payment under paragraph (b)(1)(ii) of this section.

Example 4. Costs to facilitate. W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 5 years. W pays its outside counsel \$7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. Under para-

graph (e)(1)(i) of this section, W's payment to its outside counsel is an amount paid to facilitate W's creation of an intangible asset. As provided by paragraph (e)(5) of this section, W must capitalize its \$7,000 payment to outside counsel notwithstanding the fact that W made no payment described in paragraph (d)(6)(i) of this section to induce X to enter into the agreement.

Example 5. Costs to facilitate. Q corporation seeks to acquire all of the outstanding stock of Y corporation. To finance the acquisition, Q must issue new debt. Q pays an investment banker \$25,000 to market the debt to the public and pays its outside counsel \$10,000 to prepare the offering documents for the debt. Q's payment of \$35,000 facilitates a borrowing and must be capitalized under paragraph (b)(1)(iii) of this section. As provided in paragraph (e)(1)(iii) of this section, Q's payment does not facilitate the acquisition of Y, notwithstanding the fact that Q incurred the new debt to finance its acquisition of Y.

Example 6. Costs that do not facilitate. X corporation brings a legal action against Y corporation to recover lost profits resulting from Y's alleged infringement of X's copyright. Y does not challenge X's copyright, but argues that it did not infringe upon X's copyright. X pays its outside counsel \$25,000 for legal services rendered in pursuing the suit against Y. Because X's title to its copyright is not in question, X's action against Y does not involve X's defense or perfection of title to intangible property. Thus, the amount paid to outside counsel does not facilitate the creation or enhancement of an intangible asset described in paragraph (d)(9) of this section. In addition, the amount paid to outside counsel does not facilitate the acquisition, creation, or enhancement of any other intangible asset described in this section. Accordingly, X is not required to capitalize its \$25,000 payment under this section.

Example 7. De minimis rule. W corporation, a commercial bank, acquires a portfolio containing 100 loans from Y corporation. W pays an independent agent a commission of \$10,000 for brokering the acquisition. The commission is an amount paid to facilitate W's acquisition of an intangible asset. The acquisition of the loan portfolio is a single transaction within the meaning of paragraph (e)(2) of this section. Because the amounts paid to facilitate the transaction exceed \$5,000, the amounts are not *de minimis* as defined in paragraph (e)(3)(ii)(A) of this section. Accordingly, W must capitalize the \$10,000 commission under paragraph (b)(1)(ii) of this section.

Example 8. Compensation and overhead. P corporation, a commercial bank, maintains a loan acquisition department whose sole function is to acquire loans from other financial institutions. As provided in paragraph (e)(3)(i) of this section, P is not required to capitalize any portion of the compensation paid to the employees in its loan acquisition department or any portion of its overhead allocable to the loan acquisition department.

Example 9. Corporate acquisition. (i) On February 1, 2002, R corporation decides to investigate the acquisition of three potential targets: T corporation, U corporation, and V corporation. R's consideration of T, U, and V represents the consideration of three distinct transactions, any or all of which R might consummate. On March 1, 2002, R issues a letter of intent to T and stops pursuing U and V. On July 1, 2002, R acquires the stock of T in a transaction described

in section 368. R pays \$1,000,000 to an investment banker and \$50,000 to its outside counsel to conduct due diligence on the targets, determine the value of T, U, and V, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain the necessary regulatory approvals.

(ii) Under paragraph (e)(4)(i)(A) of this section, the amounts paid to conduct due diligence on T, U, and V prior to March 1, 2002 (the date of the letter of intent), are not amounts paid to facilitate the acquisition of the stock of T and are not required to be capitalized under this paragraph (e). However, the amounts paid to conduct due diligence on T on and after March 1, 2002, are amounts paid to facilitate the acquisition of the stock of T and must be capitalized under paragraph (b)(1)(ii) of this section.

(iii) Under paragraph (e)(4)(i)(B) of this section, the amounts paid to determine the value of T, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain necessary regulatory approvals are inherently facilitative amounts paid to facilitate the acquisition of the stock of T and must be capitalized, regardless of whether those activities occur prior to March 1, 2002.

(iv) Under paragraph (e)(4)(i)(B) of this section, the amounts paid to determine the value of U and V are inherently facilitative amounts paid to facilitate the acquisition of U or V and must be capitalized. However, these fees may be recovered under section 165 in the taxable year that R abandons the planned mergers with U and V.

Example 10. Corporate acquisition; employee bonus. Assume the same facts as in *Example 9*, except R pays a bonus of \$10,000 to one of its corporate officers who negotiated the acquisition of T. As provided by paragraph (e)(3)(i) of this section, Y is not required to capitalize any portion of the bonus paid to the corporate officer.

Example 11. Corporate acquisition; integration costs. Assume the same facts as in *Example 9*, except that, before and after the acquisition is consummated, R incurs costs to relocate personnel and equipment, provide severance benefits to terminated employees, integrate records and information systems, prepare new financial statements for the combined entity, and reduce redundancies in the combined business operations. Under paragraph (e)(4)(i)(D) of this section, these costs do not facilitate the acquisition of T. Accordingly, R is not required to capitalize any of these costs under this section.

Example 12. Corporate acquisition; compensation to target's employees. Assume the same facts as in *Example 9*, except that, prior to the acquisition, certain employees of T held unexercised options issued pursuant to T's incentive stock option plan. These options granted the employees the right to purchase T stock at a fixed option price. The options did not have a readily ascertainable value (within the meaning of § 1.83-7(b)), and thus no amount was included in the employees' income when the options were granted. As a condition of the acquisition, T is required to terminate its incentive stock option plan. T therefore agrees to pay its employees who hold un-

exercised stock options the difference between the option price and the current value of T's stock in consideration of their agreement to cancel their unexercised options. Under paragraph (e)(3)(i) of this section, T is not required to capitalize the amounts paid to its employees.

Example 13. Corporate acquisition; retainer. Y corporation's outside counsel charges Y \$60,000 for services rendered in facilitating the friendly acquisition of the stock of Y corporation by X corporation. Y has an agreement with its outside counsel under which Y pays an annual retainer of \$50,000. Y's outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y's outside counsel offsets \$50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of \$10,000. The \$60,000 legal fee is an amount paid to facilitate the reorganization of Y as described in paragraph (e)(1)(i) of this section. Y must capitalize the full amount of the \$60,000 legal fee.

Example 14. Corporate acquisition; antitrust defense costs. On March 1, 2002, V corporation enters into an agreement with X corporation to acquire all of the outstanding stock of X. On April 1, 2002, federal and state regulators file suit against V to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. V enters into a consent agreement with regulators on May 1, 2002, that allows the acquisition to proceed, but requires V to hold separate the business operations of X pending the outcome of the antitrust suit and subjects V to possible divestiture. V acquires title to all of the outstanding stock of X on June 1, 2002. After June 1, 2002, the regulators pursue antitrust litigation against V seeking rescission of the acquisition. V pays \$50,000 to its outside counsel for services rendered after June 1, 2002, to defend against the antitrust litigation. V ultimately prevails in the antitrust litigation. V's costs to defend the antitrust litigation are costs to facilitate its acquisition of the stock of X under paragraph (e)(1)(i) of this section and must be capitalized. Although title to the shares of X passed to V prior to the date V incurred costs to defend the antitrust litigation, the amounts paid by V are paid in the process of pursuing the acquisition of the stock of X because the acquisition was not complete until the antitrust litigation was ultimately resolved. Because the amounts paid to defend the suit are not *de minimis* costs within the meaning of paragraph (e)(3)(ii)(A) of this section, V must capitalize the full \$50,000.

Example 15. Corporate acquisition; hostile defense costs. (i) Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation on January 15, 2002. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential "white knight" acquirer, as well as costs to effect a recapitalization. Y's efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2002, Y's Board of Directors decides to abandon its defense against the takeover and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its defense against the takeover, Y pays its investment bankers \$1,000,000 for a fairness opinion and for services rendered in negotiating with Z.

(ii) Under paragraph (e)(4)(iii)(A) of this section, the legal fees paid by Y to seek an injunction

against the takeover and the investment banking fees paid to search for a white knight acquirer do not facilitate the acquisition of Y by Z. Such amounts are paid to defend against Z's hostile takeover attempt and are not required to be capitalized under this section.

(iii) Under paragraph (e)(4)(iii)(B) of this section, the amounts paid by Y to effect a recapitalization are not amounts paid to defend against a hostile acquisition attempt. Accordingly, the amounts paid to effect the recapitalization must be capitalized under paragraph (b)(1)(iii) of this section.

(iv) The \$1,000,000 paid to the investment bankers after Y abandons its defense against the takeover is an amount paid to facilitate an acquisition of Y and must be capitalized under paragraph (b)(1)(iii) of this section.

Example 16. Corporate acquisition; break up fees.

(i) N corporation enters into an agreement with U corporation under which U agrees to purchase all of the outstanding stock of N for \$70 per share. The agreement between N and U provides that if the acquisition does not succeed, N will pay U \$1,000,000 as a break up fee. Prior to the closing of the acquisition, N enters into an agreement with W under which W agrees to purchase all of the outstanding stock of N for \$80 per share on the condition that N terminates its pending acquisition agreement with U. N pays U \$1,000,000 to terminate the acquisition agreement and N subsequently is acquired by W. Under paragraph (e)(1)(ii) of this section, the \$1,000,000 paid to U is an amount paid to facilitate a transaction described in paragraph (b)(1)(iii) of this section. Accordingly, N must capitalize the \$1,000,000 payment.

Example 17. Corporate acquisition; break up fees to white knight. Z corporation launches an unsolicited hostile tender offer of \$70 per share for 55 percent of the outstanding shares of T corporation. In an effort to defend against a takeover by Z, T enters into an agreement with W corporation, a "white knight" acquirer, under which W agrees to pay \$75 per share for all outstanding shares of T if T agrees to recommend the transaction to its shareholders. The agreement between T and W provides that if the acquisition of T by W does not succeed, T will pay W \$1,000,000 as a break up fee. Prior to the acquisition of T by W, Z amends its offer to \$85 per share for all of the outstanding shares of T. T's Board of Directors concludes that Z's amended offer is preferable and recommends that its shareholders accept Z's amended offer. Z subsequently acquires all of the outstanding shares of T for \$85 per share. In accordance with its agreement with W, T pays W \$1,000,000 to terminate the acquisition agreement. The \$1,000,000 paid to W does not facilitate Z's acquisition of the outstanding shares of T. Under paragraph (e)(1)(ii) of this section, T's payment to W is not made pursuant to an agreement under which the acquisition of the outstanding shares of T by Z is expressly conditioned on the termination of the agreement between T and W.

(f) *12-month rule* — (1) *In general* —

(i) *Amounts paid to create or enhance an intangible asset.* A taxpayer is not required to capitalize amounts paid to create or enhance an intangible asset if the amounts do

not create or enhance any right or benefit for the taxpayer that extends beyond the earlier of —

(A) 12 months after the first date on which the taxpayer realizes the right or benefit; or

(B) The end of the taxable year following the taxable year in which the payment is made.

(ii) *Transaction costs.* A taxpayer is not required to capitalize amounts paid to facilitate the creation or enhancement of an intangible asset if, by reason of paragraph (f)(1)(i) of this section, capitalization would not be required for amounts paid to create or enhance that intangible asset.

(2) *Duration of benefit for contract terminations.* For purposes of this paragraph (f), amounts paid to terminate a contract or other agreement described in paragraph (d)(7)(i) of this section prior to its expiration date (or amounts paid to facilitate such termination) create a benefit for the taxpayer equal to the unexpired term of the agreement as of the date of the termination.

(3) *Inapplicability to created financial interests and self-created amortizable section 197 intangibles.* Paragraph (f)(1) of this section does not apply to amounts paid to create or enhance an intangible described in paragraph (d)(2) of this section (relating to amounts paid to create or enhance financial interests) or to amounts paid to create or enhance an intangible asset that constitutes an amortizable section 197 intangible within the meaning of section 197(c).

(4) *Inapplicability to rights of indefinite duration.* Paragraph (f)(1) of this section does not apply to amounts paid to create or enhance a right of indefinite duration. A right has an indefinite duration if it has no period of duration fixed by agreement or by law, or if it is not based on a period of time, such as a right attributable to an agreement to provide or receive a fixed amount of goods or services. For example, a license granted by a governmental agency that permits the taxpayer to operate a business conveys a right of indefinite duration if the license may be revoked only upon the taxpayer's violation of the terms of the license.

(5) *Rights subject to renewal* — (i) *In general.* For purposes of paragraph (f)(1)(i) of this section, the duration of a right in-

cludes any renewal period if, based on all of the facts and circumstances in existence during the taxable year in which the right is created, the facts indicate a reasonable expectancy of renewal.

(ii) *Reasonable expectancy of renewal.*

The following factors are significant in determining whether there exists a reasonable expectancy of renewal:

(A) *Renewal history.* The fact that similar rights are historically renewed is evidence of a reasonable expectancy of renewal. On the other hand, the fact that similar rights are rarely renewed is evidence of a lack of a reasonable expectancy of renewal. Where the taxpayer has no experience with similar rights, or where the taxpayer holds similar rights only occasionally, this factor is less indicative of a reasonable expectancy of renewal.

(B) *Economics of the transaction.* The fact that renewal is necessary in order for the taxpayer to earn back its investment in the right is evidence of a reasonable expectancy of renewal. For example, if a taxpayer pays \$10,000 to enter into a renewable contract with an initial 9-month term that is expected to generate income to the taxpayer of \$1,000 per month, the fact that renewal is necessary in order for the taxpayer to earn back its \$10,000 inducement is evidence of a reasonable expectancy of renewal.

(C) *Likelihood of renewal by other party.* Evidence that indicates a likelihood of renewal by the other party to a right, such as a bargain renewal option or similar arrangement, is evidence of a reasonable expectancy of renewal. However, the mere fact that the other party will have the opportunity to renew on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value, is not evidence of a reasonable expectancy of renewal.

(D) *Terms of renewal.* The fact that material terms of the right are subject to renegotiation at the end of the initial term is evidence of a lack of a reasonable expectancy of renewal. For example, if the parties to an agreement must renegotiate price or amount, the renegotiation requirement is evidence of a lack of a reasonable expectancy of renewal.

(ii) *Safe harbor pooling method.* In lieu of applying the reasonable expectancy of renewal test described in paragraph (f)(5)(ii)

of this section to each separate right created or enhanced during a taxable year, a taxpayer may establish one or more pools of similar rights for which the initial term does not extend beyond the period described in paragraph (f)(1)(i) of this section and may apply the reasonable expectancy of renewal test to each pool. See paragraph (h) of this section for additional rules relating to pooling. The application of paragraph (f)(1) of this section to each pool is determined in the following manner:

(A) All amounts (except *de minimis* amounts described in paragraph (d)(6)(ii) of this section) paid to create or enhance the rights included in the pool and all amounts paid to facilitate the creation or enhancement of the rights included in the pool are aggregated.

(B) If less than 20 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section, all rights in the pool are treated as having a duration that does not extend beyond the period prescribed in paragraph (f)(1)(i) of this section, and the taxpayer is not required to capitalize under this section any portion of the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(C) If more than 80 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section, all rights in the pool are treated as having a duration that extends beyond the period prescribed in paragraph (f)(1)(i) of this section, and the taxpayer is required to capitalize under this section the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(D) If 20 percent or more, but 80 percent or less, of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section, the aggregate amount described in paragraph (f)(5)(iii)(A) of this section is multiplied by the percentage of the rights in the pool that are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section and the taxpayer must capitalize the resulting amount under this section by treating such amount as creating a separate intangible asset.

(6) *Rights terminable at will.* A right is not described in paragraph (f)(1)(i) of this section merely because the right is termi-

nable at will by either party. However, for purposes of paragraph (f)(5) of this section, the fact that similar rights are typically terminated prior to renewal is relevant in determining whether there exists a reasonable expectancy of renewal for the right.

(7) *Coordination with section 461.* In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See § 1.461-4(d) for rules relating to economic performance.

(8) *Examples.* The rules of this paragraph (f) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer is a calendar year, accrual method taxpayer:

Example 1. Prepaid expenses. On December 1, 2002, N corporation pays a \$10,000 insurance premium to obtain a property insurance policy with a 1-year term that begins on February 1, 2003. The amount paid by N is a prepaid expense described in paragraph (d)(3) of this section. Because the right or benefit attributable to the \$10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule provided by this paragraph (f) does not apply. N must capitalize the \$10,000 payment.

Example 2. Prepaid expenses. Assume the same facts as in *Example 1*, except that the policy has a term beginning on December 15, 2002. The 12-month rule of this paragraph (f) applies to the \$10,000 payment because the right or benefit attributable to the payment 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 in which the payment is made. Accordingly, N is not required to capitalize the \$10,000 payment.

Example 3. Financial interests. On October 1, 2002, X corporation makes a 9-month loan to B in the principal amount of \$250,000. The principal amount of the loan paid to B constitutes an amount paid to create or originate a financial interest under paragraph (d)(2)(i)(B) of this section. The 9-month term of the loan does not extend beyond the period prescribed by paragraph (f)(1)(i) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, X must capitalize the \$250,000 loan amount.

Example 4. Financial interests. X corporation owns all of the outstanding stock of Z corporation. On December 1, Y corporation, a calendar year taxpayer, pays X \$1,000,000 in exchange for X's grant of a 9-month call option to Y permitting Y to purchase all of the outstanding stock of Z. Y's payment to X constitutes an amount paid to create or originate an option with X under paragraph (d)(2)(i)(C)(7) of this section. The 9-month term of the option does not extend beyond the period prescribed by paragraph (f)(1)(i)

of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, Y must capitalize the \$1,000,000 payment.

Example 5. License. (i) On July 1, 2002, R corporation pays \$10,000 to state X to obtain a license to operate a business in state X for a period of 5 years. The terms of the license require R to pay state X an annual fee of \$500 due on July 1 of each of the succeeding four years. R pays the \$500 fee on July 1 of each succeeding year as required by the license.

(ii) R's payment of \$10,000 is an amount paid to a governmental agency for a license granted by that agency to which paragraph (d)(5) of this section applies. Because R's payment creates rights or benefits for R that extend beyond the end of 2003 (the taxable year following the taxable year in which the payment is made), the rules of this paragraph (f) do not apply to R's payment. Accordingly, R must capitalize the \$10,000 payment.

(iii) R's payment of each \$500 annual fee is a prepaid expense described in paragraph (d)(3) of this section. R is not required to capitalize the \$500 fee in each of the succeeding four taxable years. The rules of this paragraph (f) apply to each such payment because each payment provides a right or benefit to R that does not extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and does not extend beyond the end of the taxable year following the taxable year in which the payment is made.

Example 6. Lease. On December 1, 2002, W corporation, a calendar year taxpayer, enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 9 months, beginning on December 1, 2002. W pays its outside counsel \$7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. W's \$7,000 payment to its outside counsel is an amount paid to facilitate W's creation of an intangible asset as described in paragraph (e)(1)(i) of this section. Under paragraph (f)(1)(ii) of this section, W's payment to its outside counsel is not required to be capitalized because, by reason of paragraph (f)(1)(i) of this section (relating to the 12-month rule) an amount described in paragraph (d)(6)(i)(A) of this section to create the agreement between W and X would not be required to be capitalized under this section.

Example 7. Certain contract terminations. V corporation owns real property that it has leased to A for a period of 15 years. When the lease has a remaining unexpired term of 5 years, V requests that A agree to terminate the lease, enabling V to use the property in its trade or business. V pays A \$100,000 in exchange for A's agreement to terminate the lease. V's payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 5 years, the remaining unexpired term of the lease as of the date of the termination. Because the benefit attributable to the expenditure extends beyond 12 months after the first date on which V realizes the rights or benefits attributable to the payment and beyond the end of the taxable year following the taxable year in which the

payment is made, the rules of this paragraph (f) do not apply to the payment. V must capitalize the \$100,000 payment.

Example 8. Certain contract terminations. Assume the same facts as in *Example 7*, except the lease is terminated when it has a remaining unexpired term of 10 months. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 10 months. The 12-month rule of this paragraph (f) applies to the payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the taxable year following the year in which the payment is made. Accordingly, V is not required to capitalize the \$100,000 payment.

Example 9. Certain contract terminations. M corporation enters into a 5-year agreement with X corporation under which X is required to provide M with services over the term of the agreement. Under the terms of the agreement, either M or X may terminate the agreement without cause upon 30 days notice. M pays C, an individual, a \$10,000 commission for services provided by C in locating X and bringing the parties together. The agreement between M and X is an agreement providing M the right to acquire services as described in paragraph (d)(6)(i)(B) of this section. M's \$10,000 payment to C is an amount paid to facilitate the creation of an intangible asset as described in paragraph (e)(1)(i) of this section. Because the duration of the contract is 5 years, the 12-month rule contained in paragraph (f)(1)(i) of this section does not apply, notwithstanding the fact that the agreement is terminable by either party without cause upon 30 days notice. M must capitalize the \$10,000 commission payment.

Example 10. Coordination with section 461. (i) U corporation leases office space from W corporation at a monthly rental rate of \$2,000. On December 31, 2002, U prepays its office rent expense for the first six months of 2003 in the amount of \$12,000. For purposes of this example, it is assumed that the recurring item exception provided by § 1.461-5 does not apply and that the lease between W and U is not a section 467 rental agreement as defined in section 467(d).

(ii) Under § 1.461-4(d)(3), U's prepayment of rent is a payment for the use of property by U for which economic performance occurs ratably over the period of time U is entitled to use the property. Accordingly, because economic performance with respect to U's prepayment of rent does not occur until 2003, U's prepaid rent is not incurred in 2002 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2002. Thus, the rules of this paragraph (f) do not apply to U's prepayment of its rent.

(iii) Alternatively, assume that U uses the cash method of accounting and the economic performance rules in § 1.461-4 therefore do not apply to U. The 12-month rule of this paragraph (f) applies to the \$12,000 payment because the rights or benefits attributable to U's prepayment of its rent do not extend beyond December 31, 2003. Accordingly, U is not required to capitalize its prepaid rent.

Example 11. Coordination with section 461. N corporation pays R corporation, an advertising and marketing firm, \$40,000 on August 1, 2002, for advertising and marketing services to be provided to N throughout calendar year 2003. For purposes of this example, it is assumed that the recurring item exception

provided by § 1.461-5 does not apply. Under § 1.461-4(d)(2), N's payment arises out of the provision of services to N by R for which economic performance occurs as the services are provided. Accordingly, because economic performance with respect to N's prepaid advertising expense does not occur until 2003, N's prepaid advertising expense is not incurred in 2002 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2002. Thus, the rules of this paragraph (f) do not apply to N's payment.

(g) *Treatment of capitalized transaction costs* — (1) *Costs described in paragraph (b)(1)(i) or (ii) of this section.* Except in the case of amounts paid by an acquirer to facilitate an acquisition of stock or assets in a transaction described in section 368, an amount required to be capitalized by paragraph (b)(1)(i) or (ii) of this section is capitalized to the basis of the intangible asset acquired, created, or enhanced.

(2) *Costs described in paragraph (b)(1)(iii) of this section* — (i) *Stock issuance or recapitalization.* An amount paid to facilitate a stock issuance or a recapitalization is not capitalized to the basis of an intangible asset but is treated as a reduction of the proceeds from the stock issuance or the recapitalization.

(ii) [Reserved].

(h) *Special rules applicable to pooling* — (1) *In general.* The rules of this paragraph (h) apply to the pooling methods described in paragraph (d)(6)(ii) of this section (relating to *de minimis* rules applicable to certain contract rights), paragraph (e)(3)(ii)(C) of this section (relating to *de minimis* rules applicable to transaction costs), and paragraph (f)(5)(iii) of this section (relating to the application of the 12-month rule to renewable rights).

(2) *Election to use pooling.* An election to use a pooling method identified in paragraph (h)(1) of this section for any taxable year is made by establishing one or more pools for the taxable year in accordance with the rules governing the particular pooling method and the rules prescribed by this paragraph (h). An election to use a pooling method identified in paragraph (h)(1) of this section is irrevocable with respect to each pool established during the taxable year.

(3) *Definition of pool.* A taxpayer may use any reasonable method of defining a pool of similar transactions, agreements, or rights, including a method based on the type of customer or the type of product provided under a contract. However, a tax-

payer that elects to pool similar transactions, agreements, or rights must include in the pool all similar transactions, agreements, or rights arising during the taxable year.

(4) *Consistency requirement.* A taxpayer that uses the pooling method described in paragraph (f)(5)(iii) of this section for purposes of applying the 12-month rule to a right or benefit —

(i) Must use the pooling methods described in paragraph (d)(6)(ii) of this section (relating to *de minimis* rules applicable to inducements) and paragraph (e)(3)(ii)(C) of this section (relating to *de minimis* rules applicable to transaction costs) for purposes of determining the amount paid to create, or facilitate the creation of, the right or benefit; and

(ii) Must use the same pool for purposes of paragraph (d)(6)(ii) of this section and paragraph (e)(3)(ii)(C) of this section as is used for purposes of paragraph (f)(5)(iii) of this section.

(i) [Reserved].

(j) *Application to accrual method taxpayers.* For purposes of this section, the terms *amount paid* and *payment* mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of § 1.446-1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(k) *Treatment of related parties and indirect payments.* For purposes of this section, references to a party other than the taxpayer include persons related to that party and persons acting for or on behalf of that party. Persons are related for purposes of this section only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1).

(l) *Examples.* The following examples illustrate the rules of this section:

Example 1. License granted by a governmental unit. (i) X corporation pays \$25,000 to state R to obtain a license to sell alcoholic beverages in its restaurant. The license is valid indefinitely, provided X complies with all applicable laws regarding the sale of alcoholic beverages in state R. X pays its outside counsel \$4,000 for legal services rendered in preparing the license application and otherwise representing X during the licensing process. In addition, X determines that \$2,000 of salaries paid to its employees is allocable to services rendered by the employees in obtaining the license.

(ii) X's payment of \$25,000 is an amount paid to a governmental unit to obtain a license granted by that agency, as described in paragraph (d)(5)(i) of this section.

tion. The right has an indefinite duration and constitutes an amortizable section 197 intangible. Accordingly, the provisions of paragraph (f) of this section (relating to the 12-month rule) do not apply to X's payment. X must capitalize its \$25,000 payment to obtain the license from state R.

(iii) As provided in paragraph (e)(3) of this section, X is not required to capitalize employee compensation because such amounts are treated as amounts that do not facilitate the acquisition, creation, or enhancement of an intangible asset. Thus, X is not required to capitalize the \$2,000 of employee compensation allocable to the transaction.

(iv) X's payment of \$4,000 to its outside counsel is an amount paid to facilitate the creation of an intangible asset, as described in paragraph (e)(1)(i) of this section. Because X's transaction costs do not exceed \$5,000, X's transaction costs are *de minimis* within the meaning of paragraph (e)(3)(ii)(A) of this section. Accordingly, X is not required to capitalize the \$4,000 payment to its outside counsel under this section.

Example 2. Franchise agreement. (i) R corporation is a franchisor of income tax return preparation outlets. V corporation negotiates with R to obtain the right to operate an income tax return preparation outlet under a franchise from R. V pays an initial \$100,000 franchise fee to R in exchange for the franchise agreement. In addition, V pays its outside counsel \$4,000 to represent V during the negotiations with R. V also pays \$2,000 to an industry consultant to advise V during the negotiations with R.

(ii) Under paragraph (d)(6)(i)(A) of this section, V's payment of \$100,000 is an amount paid to another party to induce that party to enter into an agreement providing V the right to use tangible or intangible property. Accordingly, V must capitalize its \$100,000 payment to R. The franchise agreement is an amortizable section 197 intangible within the meaning of section 197(c). Accordingly, as provided in paragraph (f)(3) of this section, the 12-month rule contained in paragraph (f)(1)(i) of this section does not apply.

(iii) V's payment of \$4,000 to its outside counsel and \$2,000 to the industry consultant are amounts paid to facilitate the creation of an intangible asset, as described in paragraph (e)(1)(i) of this section. Because V's aggregate transaction costs exceed \$5,000, V's transaction costs are not *de minimis* within the meaning of paragraph (e)(3)(ii)(A) of this section. Accordingly, V must capitalize the \$4,000 payment to its outside counsel and the \$2,000 payment to the industry consultant under this section into the basis of the franchise, as provided in paragraph (g)(1) of this section.

Example 3. Covenant not to compete. (i) On December 1, 2002, N corporation, a calendar year taxpayer, enters into a covenant not to compete with B, a key employee that is leaving the employ of N. The covenant not to compete prohibits B from competing with N for a period of 9 months, beginning December 1, 2002. N pays B \$50,000 in full consideration for B's agreement not to compete. In addition, N pays its outside counsel \$6,000 to facilitate the creation of the covenant not to compete with B.

(ii) Under paragraph (d)(6)(i)(C) of this section, N's payment of \$50,000 is an amount paid to another party to induce that party to enter into a covenant not to compete with N. However, because the covenant not to compete has a duration that does not extend beyond 12 months after the first date on which

N realizes the rights attributable to its payment (*i.e.*, December 1, 2002), the 12-month rule contained in paragraph (f)(1)(i) of this section applies. Accordingly, N is not required to capitalize its \$50,000 payment to B. In addition, as provided in paragraph (f)(1)(ii) of this section, N is not required to capitalize its \$6,000 payment to facilitate the creation of the covenant not to compete.

Example 4. Corporate reorganization; initial public offering. Y corporation is a privately-owned company. Y's Board of Directors authorizes an initial public offering of Y's stock in order to fund future growth. Y pays \$5,000,000 in professional fees for investment banking services related to the determination of the offering price and legal services related to the development of the offering prospectus and the registration and issuance of stock. Under paragraph (b)(1)(iii) of this section, the \$5,000,000 is an amount paid to facilitate a transaction involving the acquisition of capital. As provided in paragraph (g)(2)(i) of this section, Y must treat the \$5,000,000 as a reduction of the proceeds from the stock issuance.

Example 5. Demand-side management. (i) X corporation, a public utility engaged in generating and distributing electrical energy, provides programs to its customers to promote energy conservation and energy efficiency. These programs are aimed at reducing electrical costs to X's customers, building goodwill with X's customers, and reducing X's future operating and capital costs. X provides these programs without obligating any of its customers participating in the programs to purchase power from X in the future. Under these programs, X pays a consultant to help industrial customers design energy-efficient manufacturing processes, to conduct "energy efficiency audits" that serve to identify for customers inefficiencies in their energy usage patterns, and to provide cash allowances to encourage residential customers to replace existing appliances with more energy efficient appliances.

(ii) The amounts paid by X to the consultant are not amounts to acquire, create, or enhance an intangible identified in paragraph (c) or (d) of this section or to facilitate such an acquisition, creation, or enhancement. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to the consultant are not required to be capitalized under this section. While the amounts may serve to reduce future operating and capital costs and create goodwill with customers, these benefits, without more, are not intangible assets for which capitalization is required under this section unless the Internal Revenue Service publishes guidance identifying these benefits as an intangible asset for which capitalization is required.

Example 6. Business process re-engineering. (i) V corporation manufactures its products using a batch production system. Under this system, V continuously produces component parts of its various products and stockpiles these parts until they are needed in V's final assembly line. Finished goods are stockpiled awaiting orders from customers. V discovers that this process ties up significant amounts of V's capital in work-in-process and finished goods inventories, and hires B, a consultant, to advise V on improving the efficiency of its manufacturing operations. B recommends a complete re-engineering of V's manufacturing process to a process known as just-in-time manufacturing. Just-in-time manufacturing in-

volves reconfiguring a manufacturing plant to a configuration of "cells" where each team in a cell performs the entire manufacturing process for a particular customer order, thus reducing inventory stockpiles.

(ii) V incurred three categories of costs to convert its manufacturing process to a just-in-time system. First, V paid B, a consultant, \$250,000 in professional fees to implement the conversion of V's plant to a just-in-time system. Second, V paid C, a contractor, \$100,000 to relocate and reconfigure V's manufacturing equipment from an assembly line layout to a configuration of cells. Third, V paid D, a consultant, \$50,000 to train V's employees in the just-in-time manufacturing process.

(iii) The amounts paid by V to B, C, and D are not amounts to acquire, create, or enhance an intangible identified in paragraph (c) or (d) of this section or to facilitate such an acquisition, creation, or enhancement. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to B, C, and D are not required to be capitalized under this section. While the amounts produce long term benefits to V in the form of reduced inventory stockpiles, improved product quality, and increased efficiency, these benefits, without more, are not intangible assets for which capitalization is required under this section unless the Internal Revenue Service publishes guidance identifying these benefits as an intangible asset for which capitalization is required.

Example 7. Defense of business reputation. (i) X, an investment adviser, serves as the fund manager of a money market investment fund. X, like its competitors in the industry, strives to maintain a constant net asset value for its money market fund of \$1.00 per share. During 2003, in the course of managing the fund assets, X incorrectly predicts the direction of market interest rates, resulting in significant investment losses to the fund. Due to these significant losses, X is faced with the prospect of reporting a net asset value that is less than \$1.00 per share. X is not aware of any investment adviser in its industry that has ever reported a net asset value for its money market fund of less than \$1.00 per share. X is concerned that reporting a net asset value of less than \$1.00 per share will significantly harm its reputation as an investment adviser, and could lead to litigation by shareholders. X decides to contribute \$2,000,000 to the fund in order to raise the net asset value of the fund to \$1.00 per share. This contribution is not a loan to the fund and does not give X any ownership interest in the fund.

(ii) The \$2,000,000 contribution is not an amount paid to acquire, create, or enhance an intangible identified in paragraph (c) or (d) of this section or to facilitate such an acquisition, creation, or enhancement. In addition, the amount does not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amount contributed to the fund is not required to be capitalized under this section. While the amount serves to protect the business reputation of the taxpayer and may protect the taxpayer from litigation by shareholders, these benefits, without more, are not intangible assets for which capitalization is required under this section unless the Internal Revenue Service publishes guidance identifying these benefits as an intangible asset for which capitalization is required.

(m) *Amortization.* For rules relating to amortization of certain intangible assets, see § 1.167(a)–3.

(n) *Intangible interests in land.* [Reserved].

(o) *Effective Date* — (1) *In general.* This section applies to amounts paid or incurred on or after the date the final regulations are published in the **Federal Register**.

(2) *Automatic consent to change method of accounting.* A taxpayer seeking to change a method of accounting to comply with this section must follow the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner’s automatic consent to a change in accounting method (Revenue Procedure 2002–9 or its successor). Any change in method of accounting to comply with this section must be made using an adjustment under section 481(a). However, for this purpose, the adjustment under section 481(a) is determined by taking into account only amounts paid or incurred on or after the date the final regulations are published in the **Federal Register**. The final regulations may provide additional terms and conditions for changes under this paragraph (o)(2).

Par. 4. Section 1.446–5 is added to read as follows:

§ 1.446–5 *Debt issuance costs.*

(a) *In general.* This section provides rules for allocating debt issuance costs over the term of the debt. For purposes of this section, the term *debt issuance costs* means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under § 1.263(a)–4(e). If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under paragraph (b) of this section.

(b) *Method of allocating debt issuance costs* — (1) *In general.* Solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See § 1.1273–2 to determine issue price. Thus, debt issuance costs increase or create original issuance discount and decrease or eliminate bond issuance premium.

(2) *Original issue discount.* Any resulting original issue discount is taken into ac-

count by the issuer under the rules in § 1.163–7, which generally require the use of a constant yield method (as described in § 1.1272–1) to compute how much original issue discount is deductible for a period. However, see § 1.163–7(b) for special rules that apply if the total original issue discount on the debt is *de minimis*.

(3) *Bond issuance premium.* Any remaining bond issuance premium is taken into account by the issuer under the rules of § 1.163–13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

(c) *Example.* The following example illustrates the rules of this section:

Example. (i) On January 1, 2004, X borrows \$10,000,000. The principal amount of the loan (\$10,000,000) is repayable on December 31, 2008, and payments of interest in the amount of \$500,000 are due on December 31 of each year the loan is outstanding. X incurs debt issuance costs of \$130,000 to facilitate the borrowing.

(ii) Under § 1.1273–2, the issue price of the loan is \$10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of \$130,000, resulting in an issue price of \$9,870,000. As a result, X treats the loan as having original issue discount in the amount of \$130,000 (stated redemption price at maturity of \$10,000,000 minus the issue price of \$9,870,000). Because this amount of original issue discount is more than a *de minimis* amount (within the meaning of § 1.1273–1(d)), X must allocate the original issue discount to each year based on the constant yield method described in § 1.1272–1(b). See § 1.163–7(a). Based on this method and a yield of 5.30%, compounded annually, the original issue discount is allocable to each year as follows: \$23,385 for 2004, \$24,625 for 2005, \$25,931 for 2006, \$27,306 for 2007, and \$28,753 for 2008.

(d) *Effective date.* This section applies to debt issuance costs incurred for debt instruments issued on or after the date final regulations are published in the **Federal Register**.

(e) *Accounting method changes* — (1) *Consent to change.* An issuer required to change its method of accounting for debt issuance costs to comply with this section must secure the consent of the Commissioner in accordance with the requirements of § 1.446–1(e). Paragraph (e)(2) of this section provides the Commissioner’s automatic consent for certain changes.

(2) *Automatic consent.* The Commissioner grants consent for an issuer to change its method of accounting for debt issuance costs incurred for debt instruments issued on or after the date final regulations

are published in the **Federal Register**. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (e)(2) applies provided—

(i) The change is made to comply with this section;

(ii) The change is made for the first taxable year for which the issuer must account for debt issuance costs under this section; and

(iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

David A. Mader,
Assistant Deputy Commissioner of
Internal Revenue.

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