IRS TO PROVIDE NEW RULES FOR CAPITALIZATION OF EXPENDITURES RELATING TO INTANGIBLE ASSETS

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Since the Supreme Court's INDOPCO[1] decision in 1992, the rules for deciding when taxpayers can deduct expenditures relating to intangible assets have been a muddle. Taxpayers have sought to deduct various expenses relating to corporate acquisitions and restructurings and other outlays relating to intangible assets. The IRS has tried to require taxpayers to capitalize such expenditures and obtain tax benefits either over time, through amortization, or on sale, through an increased basis (or never in some cases). The result has been a thicket of conflicting IRS rulings and court cases.

In an attempt to clarify the capitalization rules, the IRS issued a release on January 17, 2002 (the "Notice")[2] stating that it expects to propose new regulations later this year. The new regulations will include specific categories of expenditures that must be capitalized, a one-year rule permitting deductions of expenditures for short-lived assets, and new rules on corporate transaction costs.

The Notice is encouraging, but any assessment of the IRS initiative must await issuance of the new rules. In particular, the rules will have to address the capitalization of transaction costs incurred in connection with asset and stock acquisitions and corporate restructurings – one of the most contested areas since the INDOPCO decision. The Notice suggests the IRS may abandon some of its more aggressive attempts to require capitalization in this area, particularly with respect to employee compensation and overhead costs. The Notice however, sheds little light on some of the most controversial post-INDOPCO topics, including the capitalization of investigatory and due diligence expenses, the treatment of regular and recurring transactions and the scope of the "future benefit" requirement of INDOPCO.

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1 INDOPCO v. Comm'r, 503 U.S. 79 (1992) (expenses of target relating to friendly acquisition held nondeductible regardless whether separate and distinct additional asset was created).

2 REG-125638-01.

SUMMARY OF EXPECTED REGULATIONS

Amounts Paid to Acquire Intangible Property

The regulations will restate the general rule that capitalization would be required for amounts paid to acquire any financial interest, such as a security, option or evidence of indebtedness. In addition, amounts paid to acquire intangible property from another person would be required to be capitalized. The Notice does not break new ground in this relatively well-settled area.

Amounts Paid to Create or Enhance Certain Intangible Rights or Benefits

The regulations are expected to introduce a 12-month rule applicable to expenditures paid to create or enhance certain intangible rights or benefits. Capitalization would not be required unless the expenditure creates or enhances intangible rights or benefits for the taxpayer that extend beyond the earlier of (i) 12 months after the first day on which the taxpayer realizes the rights or benefits or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred. In addition, the regulations will list seven categories for which, subject to the 12-month rule and certain *de minimis* thresholds, capitalization would generally be required:

– Prepaid Items

  Amounts prepaid for goods, services, or other benefits to be received in the future (*e.g.*, prepaid insurance premiums).

– Market Entry Payments

  Amounts paid to an organization to obtain or renew a membership or privilege, such as payments to obtain stock trading privileges or admission to practice medicine at a hospital.

– Payments to Obtain Rights from Governmental Agencies

  Amounts paid to a governmental agency for a trade name, trademark, copyright, license, permit or other right granted by the governmental agency.

– Amounts paid to Obtain or Modify Contract Rights

  Amounts paid to induce a person to enter into, renew or renegotiate an agreement that produces contract rights enforceable by the taxpayer, including payments for leases, covenants not to compete, customer contracts and supplier contracts.

– Amounts Paid to Terminate Contracts

Amounts paid to induce another to terminate a contract, such as a lease of real or personal property or a contract that grants the exclusive right to conduct business in a defined geographic area.

– Amounts Paid in Connection with Tangible Property Owned by Another

Amounts paid to facilitate the acquisition, production or installation of tangible property that is owned by a person other than the taxpayer where the acquisition, production or installation results in an intangible future benefit to the taxpayer for which capitalization is appropriate.

– Defense or Perfection of Title to Intangible Property

Amounts paid to defend or perfect title to intangible property (*e.g.*, payments to a third party to relinquish claim to title of a taxpayer-owned trademark).

Transaction Costs

The Notice does not provide clear guidance regarding the capitalization of transaction costs related to the acquisition of intangible assets or benefits, including costs incurred in connection with asset or stock purchases. In the Notice, the IRS states that it expects to propose rules that would require a taxpayer to capitalize "certain transaction costs that facilitate the taxpayer's acquisition, creation or enhancement of intangible assets or benefits" listed in the Notice (regardless whether payments are made in respect of such acquisition, creation or enhancement). The broad and general nature of the IRS's statement of the rule makes it difficult to ascertain how the IRS will propose to apply the rule to particular controversies in this area. The Notice does provide some specific information regarding employee compensation (generally deductible except for bonuses and commissions paid with respect to transactions) and fixed overhead (generally deductible).

In addition, the IRS notes that it is considering alternative approaches to minimize uncertainty such as: (i) allowing deductions for all employee compensation (including bonuses paid with respect to the transaction), (ii) including an exception to capitalization for regular and recurring transactions, and (iii) requiring taxpayers to follow the regulatory accounting treatment of the transaction.

OPEN QUESTIONS REGARDING TRANSACTION COSTS

Although the Notice generally describes the expected approach of the forthcoming rules, several critical issues remain to be resolved regarding the capitalization of transaction costs incurred in connection with the acquisition of intangible assets.

Investigatory Expenses

The Notice does not address the issue of the deductibility of investigatory costs related to an acquisition. Traditionally, investigatory and due diligence expenses incurred prior to a taxpayer's decision to enter into an acquisition have been deductible so long as they are incurred in connection with an existing business of the taxpayer. It is not clear under current law, however, precisely when expenses cease to become investigatory expenses and instead become acquisition expenses. In Revenue Ruling 99-23,[3] the IRS ruled that investigatory expenses incurred by a company to determine "whether to enter a new business" or "which new business to enter" although not deductible currently can be amortized over five years as start-up expenditures. Such expenses, if incurred in connection with the expansion of an existing business, would be deductible. In contrast, the ruling provides that expenses incurred to facilitate the acquisition of a particular business are neither deductible nor amortizable. The ruling did not identify a specific date after which unfavorable treatment applies (*e.g.*, date of letter of intent, acquisition agreement, board approval). Rather, the IRS adopted a facts and circumstances approach. In an example in the ruling, however, the IRS suggested that a taxpayer's decision to pursue a particular acquisition occurred around the time the taxpayer's attorneys began preparing the letter of intent to enter into the transaction.

The IRS proposed a much more restrictive test for the deductibility of investigatory expenses in Norwest v. Commissioner.[4] In Norwest, which was later reversed by Wells Fargo & Co. v. Commissioner,[5] the IRS had denied deductions to a target corporation that had incurred investigatory and due diligence expenses in connection with its ultimate friendly acquisition by the acquiring corporation. The Tax Court, concurring with the IRS, held that investigatory and due diligence expenses, such as legal fees and an allocable portion of employee salaries, must be capitalized if they are "connected to" a transaction that results in a significant long-term benefit even if such expenditures do not directly facilitate an acquisition.[6] In Wells Fargo, the Eighth Circuit reversed the Tax Court's holding in Norwest and held that investigatory and due diligence expenses incurred prior to the target's "final decision" to enter into the transaction are deductible. Based upon the fact and circumstances test set forth in Revenue Ruling 99-23, the court determined the date of execution of the acquisition agreement to be the date of "final decision".

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[3] 1999-1 C.B. 998.

[4] 112 T.C. 89 (1999).

[5] 224 F.3d 874 (8th Cir. 2000).

[6] Norwest, 112 T.C. at 100.

Although the IRS conceded in Wells Fargo that expenses attributable to the "investigatory stage" of the transaction are deductible,[7] it is not clear whether the IRS will follow that position going forward. In addition, there is no clear rule specifying which event, such as the execution of the acquisition agreement or the signing of the letter of intent, is appropriate for determining the date of the acquiror's or target's "final decision".

Regular and Recurring Transactions

In the Notice, the IRS requests guidance regarding the deductibility of expenses incurred in regular and recurring transactions. Although the IRS suggests that employee costs and overhead would be deductible under the forthcoming rules, it also implies that amounts paid by a taxpayer in connection with the origination of loans, such as amounts paid to obtain a credit history or property appraisal, would not be deductible above a threshold dollar amount, even if such loans arose in the ordinary course of the taxpayer's lending business. The IRS position is inconsistent with the Third Circuit decision in PNC Bancorp, Inc. v. Commissioner.[8] In PNC Bancorp, the Third Circuit reversed a Tax Court decision in which the taxpayer bank was required to capitalize expenses incurred in marketing, researching and originating loans, including costs of obtaining credit reports, appraisals and a portion of employee salaries attributable to loan origination activities. In reaching its decision, the Third Circuit noted that such loan and marketing activities "lie at the very core of the banks' recurring, routine day-to-day business"[9] and, as such, constitute normal deductible business expenses. In a subsequent Tax Court case, Lychuk v. Commissioner,[10] however, the Tax Court departed from the PNC Bancorp decision, holding that employee salaries paid by the taxpayer to facilitate the acquisition of installment sale contracts, which activities constituted the sole business of the taxpayer, are not deductible. Although the Notice invites comments regarding regular and recurring expenses, the IRS does not provide a clear picture of its anticipated approach in this area.

Future Benefit

The Notice does not address the difficult issue of what constitutes a future benefit requiring capitalization in the context of acquisition transactions. In INDOPCO, the Supreme Court stated that, even where a separate and distinct asset is not created, a taxpayer must capitalize expenditures that result in a significant long-term benefit. The Supreme Court noted, however, that the mere presence of an "incidental future benefit" may not require

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[7] Wells Fargo, 224 F.3d at 888.

[8] 212 F.3d 822 (3rd Cir. 2000).

[9] Id. at 834.

[10] 116 T.C. 374 (1999).

capitalization.[11] Because that test is vague, taxpayers risk IRS challenge in close factual situations where the incidental nature of expenditures is difficult to prove. In particular, controversies have arisen regarding expenses incurred in connection with failed acquisitions and expenses incurred to defend against hostile acquisitions, where the future benefit associated with the expenditures may not be clear. The IRS has taken the position that where such expenses result in a long-term future benefit, capitalization is appropriate.[12] The Seventh Circuit has held in A.E. Staley Manufacturing Co. v. Commissioner,[13] however, that costs incurred to defend a business are generally deductible unless such costs directly facilitate an acquisition that benefits the taxpayer.

FOLLOW ACCOUNTING TREATMENT

The IRS also requested comments regarding whether a taxpayer should be required to follow the accounting treatment of expenditures incurred in connection with intangible assets. This proposal would represent a dramatic departure from existing law[14] and is likely to meet with considerable resistance.

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[11] INDOPCO, 503 U.S. at 87.

[12] T.A.M. 9144042.

[13] 119 F.3d 482 (7th Cir. 1997).

[14] For example, the Third Circuit in PNC Bancorp, 212 F.3d at 833, declined to follow financial accounting standards that would have required the capitalization of loan origination expenses.