FINAL REGULATIONS REGARDING CAPITALIZATION OF EXPENDITURES RELATING TO INTANGIBLE S

March 1, 2004

The IRS issued final regulations on December 31, 2003, which further clarify whether expenditures incurred in acquiring or creating intangibles and in facilitating an acquisition of a trade or business, a change in capital structure of a business entity and certain other transactions must be capitalized rather than deducted. The regulations follow, in substantial part, the approach of the proposed regulations issued a year ago. As was the case with the proposed regulations, the final regulations limit expenditures relating to intangibles that must be capitalized to specific categories of intangibles identified in the regulations and in future published guidance. In the context of business acquisitions, the regulations, while generally requiring capitalization, provide more favorable deductibility rules for taxpayers than the IRS had permitted prior to the proposed regulations, particularly with respect to employee compensation, overhead and hostile defense costs incurred in connection with such transactions.

BACKGROUND

Prior to the issuance of the proposed regulations there had been considerable controversy between taxpayers and the IRS regarding the scope of the capitalization requirements of the Supreme Court's INDOPCO[1] decision in 1992. In INDOPCO, the Supreme Court stated that taxpayers were required to capitalize costs resulting in a significant "future benefit," even if no separate and distinct asset was created. After INDOPCO, there was uncertainty regarding the scope of the "future benefit" standard articulated therein. The rules were also unclear regarding the deductibility of transaction costs incurred in connection with stock and asset acquisitions and regular recurring transaction costs incurred to acquire intangible assets in the ordinary course of business.

1 INDOPCO v. Comm'r, 503 U.S. 79 (1992) (expenses of target relating to friendly acquisition held nondeductible).

INTANGIBLE ASSETS REQUIRED TO BE CAPITALIZED

The final regulations retain the three primary categories of intangibles required to be capitalized, with some modifications.[2] As a general rule, the regulations state that capitalization is required for:

- amounts paid to acquire or create intangibles;[3]
- amounts paid to facilitate the acquisition or creation of intangibles;[4] and
- amounts paid to facilitate the acquisition of a trade or business, a change in capital structure of a business and certain other transactions.[5]

Capitalization is required for amounts paid for intangibles acquired from another person and for intangibles created by the taxpayer.[6] Intangibles created by the taxpayer include (i) amounts paid to a third party to originate, renew or renegotiate a financial interest with such party (e.g., a letter of credit, an option or a financial derivative), (ii) prepaid expenses, (iii) amounts paid to obtain or renew memberships, (iv) amounts paid to a governmental agency for a trademark, copyright, license or other similar right, (v) amounts paid to another party to enter into or renegotiate certain contracts, (vi) amounts paid to terminate certain contracts, (vii) amounts paid to acquire or improve real property owned by another and (viii) amounts paid to

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2 The final regulations modify the format of the proposed regulations. The final regulations retain in Treas. Reg. §1.263(a)-4 the rules requiring capitalization of amounts paid to acquire or create intangibles and amounts paid to facilitate the acquisition or creation of intangibles; however, the rules requiring capitalization of amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity and certain other transactions are contained in new Treas. Reg. §1.263(a)-5. Dividing the rules into two sections enabled the IRS to apply some of the simplifying conventions in the proposed regulations to certain acquisitions of tangible assets in Treas. Reg. §1.263(a)-5, while limiting the application of Treas. Reg. §1.263(a)-4 to costs of acquiring and creating intangibles.

3 Treas. Reg. §1.263(a)-4(b)(1)(i) &(ii). There are two safe harbors with respect to intangibles created by the taxpayer. First, amounts to create (or facilitate the creation of) intangibles for the taxpayer that do not extend beyond a 12-month period, other than amounts paid to create (or facilitate the creation of) financial interests or amortizable section 197 intangibles, are not required to be capitalized. In addition, created intangibles that do not have readily ascertainable lives may be amortized over a 15-year safe harbor period. The 15-year safe harbor does not apply to intangibles acquired from another party, created financial interests or transaction costs that facilitate a stock issuance, restructuring, reorganization or other transaction involving the acquisition of capital.

4 Treas. Reg. §1.263(a)-4(b)(1)(v).

5 Treas. Reg. §1.263(a)-5.

6 *Id*.

defend or protect title to intangible property.[7] In order to prevent abuse, the IRS intends to broadly construe the categories of created intangibles and will consider all the facts and circumstances.[8]

The regulations also require capitalization of amounts that create separate and distinct intangible assets.[9] This catch-all provision is more limited than the INDOPCO future benefit standard, which mandated capitalization of costs resulting in a future benefit even if no separate and distinct asset was created. Instead, amounts that result in a future benefit must be capitalized only to the extent specifically identified in the regulations or future published guidance by the IRS or Treasury Department.[10]

TRANSACTION COSTS

The regulations liberalize the post-INDOPCO position on the deductibility of transaction costs with respect to business acquisitions, changes in the capital structure of businesses and certain other transactions. Notably, the regulations permit the deduction of employee salaries attributable to these transactions, including bonuses and commissions paid to employees as a result of the completion of such transactions.

Determination of Costs that "Facilitate" Transaction

The regulations state the general rule that transaction costs that *facilitate* (i) the acquisition or creation of an intangible asset or (ii) the acquisition of a trade or business, a change in the capital structure of a business entity and certain other transactions must be capitalized.[11] An amount is paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction, based on all the facts and circumstances.[12] The regulations state that in determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid "but for" the transaction is a relevant factor, but not the only factor to be considered.[13] This rule modifies the position taken

7 Treas. Reg. §1.263(a)-4(d).

8 Treas. Reg. §1.263(a)-4(d)(1).

9 Treas. Reg. 1.263(a)-4(b)(3).

10 Treas. Reg. § 1.263(a)-4(b)(iv).

11 Treas. Reg. §1-263(a)-5(a).

12 Treas. Reg. §1.263(a)-4(e)(1)(i); Treas. Reg. §1.263(a)-5(b)(1).

13 *Id.*

in the proposed regulations, which did not consider the "but-for" nature of the cost as a relevant factor in determining whether the expenditure was paid to facilitate the transaction.[14]

Certain Acquisitive Transactions

The final regulations address whether costs incurred to investigate "covered transactions"[15] are facilitative of such acquisition and, therefore, must be capitalized. Prior to the proposed regulations, costs incurred to investigate whether to pursue an acquisition were generally deductible if incurred in connection with an existing business. On the other hand, costs incurred to pursue a specific acquisition were to be capitalized.[16] This dichotomy led to confusion under prior law regarding the point at which investigation ceases and costs become acquisition expenses. The regulations provide rules that require capitalization of investigatory costs only if such costs relate to activities performed after a "bright line date," which is the earlier of (i) the date the letter of intent (or similar document) is executed and (ii) the date the taxpayer's Board of Directors approves the material terms of the acquisition.[17] In addition, capitalization of amounts paid in the process of investigating or pursuing covered transactions is required if costs are "inherently facilitative" of the acquisition.[18] Expenditures that are inherently facilitative under the regulations include amounts incurred to secure an appraisal, formal written evaluation or fairness opinion, structure the transaction, obtain tax advice, obtain shareholder approval and convey property between the parties.[19]

Reorganizations, Restructurings & Capital Transactions

As discussed above, transaction costs that facilitate the taxpayer's restructuring or reorganization of a business entity or certain other capital transactions must be capitalized.[20] The regulations include a broad range of transactions, including taxable and tax-free reorganizations, asset and stock acquisitions, contributions to corporations, divisive

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14 Prop. Treas. Reg. §1.263(a)-4(e)(1)(i).

15 Treas. Reg. §1.263(a)-5(e)(3). These regulations are applicable to (i) taxable acquisitions of assets that constitute a business, (ii) taxable acquisitions of ownership interests in business entities if immediately after such acquisition the acquirer and the target are related and (iii) A, B, C or non-divisive D reorganizations.

16 Revenue Ruling 99-33, 1999-1 C.B. 998.

17 Treas. Reg. §1.263(a)-5(e).

18 *Id.*

19 Treas. Reg. §1.263(a)-5(e)(2).

20 Treas. Reg. §1.263(a)-5(a).

transactions, bankruptcy reorganizations, stock issuances, issuances of debt and writing of options.[21]

The regulations do not address, however, the treatment of amounts required to be capitalized in certain other transactions under Section 263(a), such as costs of a target in a taxable stock acquisition and stock issuance costs. The IRS has issued a notice announcing its intention to propose regulations regarding the treatment of these transaction costs, and has requested comments regarding the appropriate treatment of these amounts.

Hostile Takeover Defense Costs

The IRS decided that the rules in the proposed regulations for amounts paid to defend against a hostile takeover attempt were unnecessary, and could have caused confusion.[22] As such, the final regulations do not contain any special rules related to hostile acquisition attempts. The regulations do include, however, an example that illustrates that costs paid to defend against a hostile takeover are generally deductible.[23] However, if a hostile takeover becomes friendly, the taxpayer must capitalize the costs that facilitate the ultimate transaction.[24] In addition, a taxpayer must capitalize costs to defend against a hostile takeover if such costs also facilitate another capital transaction (*e.g.*, if the taxpayer pays amounts to investigate and complete a defensive recapitalization to avoid a hostile acquisition).[25]

Costs Associated with Terminated Transactions

The final regulations clarify when costs of terminating a transaction, including break-up fees, will be treated as facilitating another transaction. Under the proposed regulations, termination costs were deemed to facilitate a subsequent transaction only if the subsequent transaction was "expressly conditioned" on the termination.[26] The final regulations, instead, treat amounts paid to terminate an agreement to enter into one transaction as facilitating a subsequent transaction if the transactions are "mutually exclusive" and the agreement is terminated to enable the taxpayer to engage in the second transaction.[27] In addition, amounts

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21 Treas. Reg. §1.263(a)-5(a)(1)-(10).

22 The hostile transaction rule in the proposed regulations, like the general rule in the final regulations, would not have permitted the deduction of expenses that facilitated an acquisition. T.D. 9107 (12/31/03).

23 Treas. Reg. §1.263(a)-5(I), Example 11.

24 *Id.*

25 *Id.*

26 Prop. Treas. §Reg. 1.263(a)-4(e)(2).

27 Treas. Reg. §1.263(a)-5(c)(8).

paid to facilitate one transaction are treated as facilitating a second transaction only if the transactions are mutually exclusive and the first transaction is abandoned to enable the taxpayer to engage in the second transaction.[28] For example, if a taxpayer pays a break-up fee in connection with an abandoned transaction with X in order to pursue a merger with Y, since the taxpayer could not merge with both X and Y (i.e. the transactions are mutually exclusive), the break-up fee payment must be capitalized.[29]

Employee Compensation and Overhead Costs

One of the most significant aspects of both the proposed and final regulations is their reversal of the long-standing IRS position that employee compensation expenses attributable to capital transactions must be capitalized. Under the regulations, employee compensation and overhead costs related to a transaction are not required to be capitalized, even if the compensation is paid in the form of a bonus or commission arising from the completion of the capital transaction.[30] The regulations also treat as employee compensation certain amounts paid to persons who may not be employees of the taxpayer under other sections of the Code.[31] Specifically, the regulations provide that a guaranteed payment for services to a partner in a partnership is employee compensation.[32] In addition, annual compensation paid to a director of a corporation is treated as employee compensation.[33] Moreover, the final regulations extend the employee compensation simplifying convention to amounts paid to outside contractors for secretarial, clerical and similar administrative services, unless the outside contractors are specifically working on the solicitation materials for the acquisition or restructuring.[34]

De Minimis Transaction Costs

The regulations provide that de minimis transaction costs (*e.g.*, costs that do not exceed $5,000) do not facilitate a capital transaction and are not required to be capitalized.[35]

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28 Treas. Reg. §1.263(a)-5(c)(8).

29 Treas. Reg. §1.263(a)-5(I), Example 13.

30 Treas. Reg. 1.263(a)-4(e)(4)(ii); Treas. Reg. 1.263(a)-5(d)(2).

31 *E.g.* Section 3401(a).

32. Treas. Reg. §1.263(a)-4(e)(4)(ii); Treas. Reg. §1.263(a)-5(d)(2).

33 *Id.*

34 Treas. Reg. §1.263(a)-4(e)(4)(ii)(b); Treas. Reg. §1.263(a)-5(d)(2)(ii).

35 Treas. Reg. §1.263(a)-4(e)(4)(iii); Treas. Reg. §1.263(a)-5(d)(3).

Regular and Recurring Expenses

The final regulations continue to reflect the IRS's view, as set forth in the preamble to the proposed regulations, that employee compensation, overhead and de minimis rules provided in the regulations address the types of "regular and recurring" costs that certain taxpayers have argued should be deductible (*e.g.*, amounts paid to obtain a credit history or property appraisal in connection with the origination of loans).[36] Since other provisions in the regulations address these costs, the IRS did not provide a general rule providing for their deductibility.

EFFECTIVE DATE

The regulations are effective as of December 31, 2003.

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The foregoing is intended only as a general summary, and the proposed regulations are more complex in their entirety. Please contact Dickson G. Brown (212-455-2850; dbrown@stblaw.com), John C. Hart (212-455-2830; jhart@stblaw.com), Steven C. Todrys (212-455-3750; stodrys@stblaw.com), Charles Rappaport (212-455-2548; crappaport@stblaw.com), Katherine P. Moir (650-251-5035; kmoir@stblaw.com) or any other member of our tax department if you have questions or comments.

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36 *See* PNC Bancorp, Inv. V. Comm'r, 212 F.2d 822 (3rd Cir. 2000) (taxpayer bank permitted to deduct 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).