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IRS PROPOSES REGULATIONS REGARDING CAPITALIZATION OF EXPENDITURES RELATING TO INTANGIBLE ASSETS

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JANUARY 24, 2003

The IRS issued proposed regulations on December 18, 2002 clarifying whether expenditures incurred in creating, acquiring and enhancing intangible assets must be capitalized rather than deducted. The proposed regulations limit expenditures relating to intangible assets that must be capitalized to specific intangible assets identified in the proposed regulations and in future published regulations. In the context of business acquisitions, the proposed regulations provide more favorable deductibility rules for taxpayers than the IRS has permitted in the past, particularly with respect to employee compensation, overhead and hostile defense costs incurred in connection with such acquisitions.

Considerable controversy has arisen between taxpayers and the IRS regarding the scope of the capitalization requirements since 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 were created. Since that time, there has been uncertainty regarding the scope of the "future benefit" standard articulated in INDOPCO. The rules have also been unclear regarding the deductibility of transaction costs incurred in connection with stock and asset acquisitions and regular and recurring transaction costs incurred to acquire intangible assets in the ordinary course of business. The proposed regulations are intended to reduce the ambiguity in this area by providing specific categories of intangible assets, rights and benefits that must be capitalized.

INTANGIBLE ASSETS REQUIRED TO BE CAPITALIZED

As a general rule, the proposed regulations state that capitalization is required for:

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

- amounts paid to acquire, create or enhance an intangible asset,

- amounts paid to facilitate the acquisition, creation or enhancement of an intangible asset, and

- amounts paid to facilitate 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 assets include those acquired from another person and intangible assets created or enhanced by the taxpayer.[3] Intangible assets created by the taxpayer include (i) amounts paid to a third party to originate 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 defend or perfect title to intangible property.[4] In addition, the proposed regulations require capitalization of amounts that create a separate and distinct intangible asset.[5] 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 is created. Instead, amounts that result in a future benefit must be capitalized only to the extent specifically identified in the proposed regulations or future published guidance by the IRS or Treasury Department.[6]

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2 Prop. Treas. Reg. §1.263(a)-4(b)(1).

3 Prop. Treas. Reg. §1.263(a)-4(b)(2). There are two safe harbors with respect to intangible assets created or enhanced by the taxpayer. First, amounts to create or enhance intangible rights or benefits for the taxpayer that do not extend beyond a 12-month period, other than amounts paid to create or enhance financial interests or section 197 intangible assets, are not required to be capitalized. In addition, created or enhanced intangible assets 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 intangible assets 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 Prop. Treas. Reg. §1.263(a)-4(d)(2) through (9).

5 Prop. Treas. Reg. §1.263(a)-4(b)(2)(i)(C).

6 Prop. Treas. Reg. §1.263(a)-4(b)(2)(i)(D).

TRANSACTION COSTS

The proposed regulations liberalize the deductibility of transactions costs incurred in connection with business acquisitions in many respects. Most notably, the proposed regulations permit deduction of employee salaries attributable to acquisitions, including bonuses and commissions paid to employees as a result of the completion of such acquisitions.

Determination of Costs that "Facilitate" Transaction

The proposed regulations state the general rule that transaction costs that *facilitate* (i) the acquisition, creation or enhancement of an intangible asset or (ii) a restructuring, reorganization or capital raising transaction must be capitalized.[7] An amount is paid to facilitate a transaction if the amount is paid in the process of pursuing the transaction, based on all the facts and circumstances.[8] The proposed regulations state that whether an expenditure would or would not have been paid "but-for" the transaction is not relevant in determining whether the expenditure is paid to facilitate the transaction.[9] For example, costs related to integrating two businesses after a merger are not treated as facilitative of the merger and are not required to be capitalized under the proposed regulations.[10]

The proposed regulations address whether costs incurred to investigate the acquisition of a trade or business are facilitative of such acquisition and are therefore deductible. Under current law, costs incurred to investigate whether to pursue an acquisition are generally deductible if incurred in connection with an existing business. On the other hand, costs incurred to pursue a specific acquisition must be capitalized.[11] This dichotomy has led to confusion under current law regarding the point at which investigation ceases and costs become acquisition expenses. The proposed regulations provide a bright line rule that requires capitalization of investigatory costs only if such costs (i) are "inherently facilitative" of the acquisition or (ii) relate to activities performed after the earlier of the date of the letter of intent

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7 Prop. Treas. Reg. §1.263(a)-4(b)(1).

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

9 Id.

10 Prop. Treas. Reg. §1.263(a)-4(e)(4)(i)(D).

11 Revenue Ruling 99-23, 1999-1 C.B. 998.

or the date the taxpayer's Board of Directors approves the acquisition.[12] Expenditures that are inherently facilitative under the proposed regulations include amounts incurred to determine the value of the target, draft transactional documents, obtain tax advice regarding the transaction, secure a fairness opinion, prepare regulatory filings, obtain shareholder approval and convey property between the parties.[13]

Reorganizations and Restructurings

As discussed above, transaction costs that facilitate the taxpayer's restructuring or reorganization of a business entity or other transaction involving the acquisition of capital must be capitalized.[14] Reorganizations and restructurings include a broad range of transactions, including taxable and tax-free reorganizations, asset and stock acquisitions, contributions to corporations, divisive transactions and bankruptcy reorganizations. The proposed regulations clarify that capitalization is not required for expenditures relating to changes in business processes, such as a change in inventory processing systems.[15]

Hostile Takeover Defense Costs

Following INDOPCO, the IRS took the position that costs incurred to defend a target company against a hostile acquisition must be capitalized if such costs result in a long-term benefit to the taxpayer. In contrast, the proposed rules provide that such costs are generally deductible.[16] However, if the hostile takeover becomes friendly, the taxpayer must distinguish between costs incurred to defend against the takeover and those incurred to facilitate the ultimate transaction.[17] 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 combines with a white knight to avoid a hostile acquisition).[18]

Employee Compensation and Overhead Costs

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[12] Prop. Treas. Reg. §1.263(a)-4(e)(4)(i)(A).

[13] Prop. Treas. Reg. §1.263(a)-4(e)(4)(i)(B).

[14] Prop. Treas. Reg. §1.263(a)-4(b)(1)(iii).

[15] Prop. Treas. Reg. §1.263(a)-4(l), Example 6.

[16] Prop. Treas. Reg. §1.263(a)-4(e)(4)(iii)(A).

[17] Id.

[18] Prop. Treas. Reg. §1.263(a)-4(e)(4)(iii)(B).

One of the most notable aspects of the proposed regulations is their reversal of the long-standing IRS position that employee compensation expenses attributable to capital transactions must be capitalized. Under the proposed rules, 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 a capital transaction.[19]

De Minimis Transaction Costs

The proposed regulations also provide that de minimis transaction costs (i.e., costs that do not exceed $5,000) do not facilitate a capital transaction and are not required to be capitalized.[20]

Regular and Recurring Expenses

In the preamble to the proposed regulations, the IRS notes that it did not provide a general rule providing deductibility of "regular and recurring" transaction costs, citing concerns regarding the administrability of such a rule. Taxpayers have argued that regular and recurring transaction costs, such as amounts paid to obtain a credit history or property appraisal in connection with the origination of loans, should be deductible.[21] In the IRS's view, the employee compensation, overhead and de minimis rules provided in the proposed regulations address the types of regular and recurring costs appropriately excluded from capitalization.

PROPOSED EFFECTIVE DATE

The regulations are proposed to be effective on the date the final regulations are published.[22]

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[19] Prop. Treas. Reg. §1.263(a)-4(e)(3)(i).

[20] Prop. Treas. Reg. §1.263(a)-4(e)(3)(ii).

[21] 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).

[22] Prop. Treas. Reg. §1.263(a)-4(o).

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), Katharine 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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