The following comments and recommendations express the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments and recommendations were prepared by members of the Section’s Committee on Tax Accounting. Primary responsibility was exercised by Kenneth E. Kempson, Chair of that Committee. Committee members Bradley Borden, Erik M. Jensen and Leslie J. Schneider also participated substantially in the development and preparation of the comments, as did Jerald David August, former Council Director to the Committee. The comments were reviewed by Robert H. Wellen of the Section’s Committee on Government Submissions and by Rudolph R. Ramelli, the current Council Director for the Committee on Tax Accounting.

All of the Section of Taxation members who participated in preparing these comments and recommendations (or members of their firms) have clients (or, in the case of Mr. Kempson, are employed by a company) that would be affected by the federal tax principles addressed, or have advised clients on the application of such principles. However, none of the participating members (or the firm to which any such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

Certain members of the Tax Accounting Committee who were prevented from participating directly in this comment project, under the Section’s conflict of interest guidelines, did provide materials and comments for consideration by the direct participants in formulating their comments and recommendations. None of these persons was involved in decision-making deliberations with respect to the content of the comments.

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Dated: September 26, 2002
September 26, 2002

ABA Tax Section
Comments on Capitalization ANPRM

Executive Summary

This document provides comments prepared by members of the American Bar Association Section of Taxation on the Advance Notice of Proposed Rulemaking (ANPRM) published in the Federal Register on January 24, 2002. The ANPRM describes rules and standards that the Internal Revenue Service and the Department of the Treasury expect to issue in 2002, in the form of proposed regulations, to provide guidance on the appropriate tax treatment of costs incurred in acquiring, creating, or enhancing certain intangible assets or benefits. The ANPRM outlines certain positions the IRS and Treasury Department expect to take, identifies others that are under consideration, and requests comments on a number of issues.

The IRS and Treasury are to be commended for this action. Workable guidance is very welcome in this area, and we are particularly pleased that comments have been solicited at such an early stage of the rulemaking process. It is particularly noteworthy that the ANPRM’s suggested guidance has been developed not only with an eye to preventing the distortion of taxable income, but also to the cost of recordkeeping and compliance burdens of taxpayers, as well as the efficient use of the government’s administrative resources. As the comments indicate, while some changes in (and clarifications of) the principles set out in the ANPRM may be desirable, the ANPRM represents a significant step in the right direction.

The ANPRM is particularly welcome because of the uncertainty that has developed following the Supreme Court’s decision in \textit{INDOPCO, Inc. v. Commissioner},\footnote{503 U.S. 79 (1992).} which revived interest in capitalization issues. As the IRS has regularly recognized and as the Court itself emphasized, the decision in \textit{INDOPCO} was based on preexisting law. When a question arises about whether expensing or capitalization is appropriate, the goal is to clearly reflect a taxpayer’s income—nothing more, nothing less. \textit{INDOPCO} did not purport to create new legal principles, and, in any event, there had been no statutory change that would have justified such a step. The general principle enunciated in \textit{INDOPCO}, which merely reflected prior law, is that capitalization should be required only if an expenditure creates significant future benefits.

Against this background, we believe that three interrelated principles inform the development of capitalization rules that implement the significant-future-benefits standard: (1) The rules should be as simple as possible; (2) they should be easily administrable; and (3) they should provide for as much certainty as possible. Even when theoretically correct, complex rules often increase uncertainty, increase taxpayers’ cost to comply, and consume limited IRS resources. We believe the guidance suggested in the ANPRM follows these principles. Nonetheless, these comments occasionally reflect areas in which the guidelines set out in the ANPRM could be expanded or modified to conform more closely to the goals of simplicity, administrability, and certainty in determining whether to capitalize expenses through clear
bright-line rules.

One goal of this submission is to identify additional issues that may need to be addressed in situations when these capitalization issues arise. We have also made recommendations as to how these situations should be treated. Even apart from the recommendations, however, we hope that the identification of issues will itself be helpful. Some of the situations and our recommendations are as follows:

We agree that costs paid to another person to acquire from that person an intangible asset should be capitalized, as well as costs to acquire, originate, or create certain financial assets. It may be useful to clarify that the amount paid to “originate” these assets is the amount paid to the obligor and not incidental transaction costs.

We support the promulgation of a “12-month rule” that avoids wasteful uncertainty and controversy regarding short-lived intangible assets. This rule should be equally available to cash and accrual taxpayers, and it should not be conditioned on any particular financial accounting treatment.

We suggest specific rules for handling contracts of indefinite duration that focus on whether the taxpayer has a meaningful legal right, rather than the nominal duration of an acquired contract.

Subject to the “12-month rule,” we support the capitalization of amounts paid for goods, services or other benefits received in the future, so long as the payment gives rise to legally enforceable rights.

We support the capitalization of amounts paid to an organization to obtain or renew a membership privilege from that organization. The proposed regulations should preserve the distinction between these costs that enable entry into a market (capitalized) and costs that merely facilitate the conduct of business, such as ISO 9000 and other certifications (deducted).

We support the capitalization of amounts paid to a governmental agency for a trade name, trademark, copyright, license, permit, or other right granted by that governmental agency.

We agree that it is appropriate to require capitalization of amounts paid to induce another party to enter into, renew or renegotiate an agreement that produces rights that are legally enforceable by the taxpayer.

We agree that capitalization is appropriate when a lessor terminates a lease or a taxpayer terminates a contract that grants another person the exclusive right to conduct business in a defined geographic area. In each of these circumstances, the payor receives back potentially valuable tangible property or intangible rights. We suggest explicit clarification that in other circumstances contract termination payments are deductible unless they constitute an inducement to the other party to enter into a new legally binding arrangement.

We support capitalization of amounts paid in connection with tangible property owned by another when the taxpayer’s benefit is of the same magnitude and nature as if the tangible property were owned by the taxpayer.

We support capitalization of amounts paid to defend or perfect title to intangible property, but suggest rules that would avoid extending this to the enforcement of the intangible rights. Thus, for example, defense of a copyright would be capitalized, but the cost to prevent violation of the copyright would be deductible.
We generally support the ANPRM’s approach to costs related to corporate transactions, such as capitalization of outside costs incurred after the “whether and which” decision is made and the deduction of all internal costs other than commissions and bonuses that are directly and explicitly related to the transaction. We suggest that, when the benefit does not have an ascertainable duration, any such capitalized costs should be recoverable over a default period (such as 5 or 15 years).

We recommend that the forthcoming regulations clarify that post-acquisition integration costs are not capitalized.

This paper also responds to the ANPRM’s request for comments on other matters. For example, we suggest that a book-tax conformity rule for capitalization is not workable for a variety of reasons. We recommend that current rules should continue to govern amounts paid to develop software, and that a taxpayer should be treated as developing software if it bears the functional risk of development. We believe the proposed regulations should provide for the deductibility of regular and recurring operations costs. We do not believe there is a single, general capitalization standard that can or should be used to identify other capitalizable costs of acquiring, creating or enhancing intangible assets or benefits. Nonetheless, authority should be retained to address quickly and effectively any unforeseen and significant distortions of income that may arise.

We recognize the administrative efficiency of a de minimis threshold below which most expenditures need not be capitalized. We believe such a rule can be implemented either through a single threshold for all taxpayers, or a two-level threshold based on a taxpayer’s historical gross receipts. Such a de minimis threshold should not apply to amounts paid to acquire or originate section 197 intangibles or certain other financial-type assets.

We believe that administrative efficiency would also be served by a default amortization period for costs related to intangible assets and benefits that do not have an ascertainable useful life. A default recovery period, such as 5 or 15 years, would remove much of the wasteful controversy and uncertainty in this area. This default period need not be of the same duration as the default period provided for corporate transaction costs.

The paper suggests effective date and transition rules designed to meet the goals of administrability. For example, automatic changes to the new methods should be available on a cut-off basis to encourage prompt and consistent compliance, without encouraging wasteful efforts to seek out and calculate favorable section 481(a) adjustments. We encourage the IRS to use the new regulations to the greatest extent possible as a template for resolving disputes in past years.

We believe application of these principles from the ANPRM will result in greater taxpayer compliance and a more efficient and fairer tax system.

I. Costs of Acquiring, Creating, or Enhancing Intangible Assets or Benefits

A. Amounts Paid to Another to Acquire Intangible Property

1. In General

The ANPRM provides that, under the expected regulations, capitalization will be required for an amount paid to another person to purchase or otherwise acquire intangible
property from that person. For example, an amount paid to another person to acquire an amortizable section 197 intangible from that person would be capitalized. Thus, a taxpayer that acquires a customer base from another person would be required to capitalize the amount paid to that person in exchange for the customer base. On the other hand, a taxpayer that incurs costs to create its own customer base through advertising or other expenditures that create customer goodwill would not be required to capitalize such costs under this rule.

We support this position. It is fundamental to the matching of income that the recovery of costs be matched to the income-producing life of an asset, whether it be tangible or intangible. Further, these costs are readily apparent to taxpayers (and examining agents) and constitute the bulk of costs related to most intangible assets.

2. Amounts Paid to Another to Acquire Financial Interests

The ANPRM also provides that, under the expected regulations, capitalization will be required for an amount paid to purchase, originate, or otherwise acquire a security, option, any other financial interest described in section 197(e)(1), or any evidence of indebtedness. For example, a financial institution that acquires portfolios of loans from another person or originates loans to borrowers would be required to capitalize the amounts paid for the portfolios or the amounts loaned to borrowers.

For the reasons noted immediately above, we also support this position. To reduce confusion, however, it may be advisable to clarify that amounts paid to “originate” these financial instruments comprise only the amounts paid to the obligor under the instrument, but do not include other incidental transactions costs, such as internal salaries or payments to contractors. These costs are addressed by other rules in the proposed guidance. For example, in the case of a taxpayer that lends money to another person, this rule requires capitalization of the amount provided to the obligor, but does not address the treatment of internal salaries and overhead or the cost of related credit reports. Unless captured under a specific rule set forth below, the internal costs related to the intangible asset would be deductible.

B. Costs of Creating or Enhancing Intangible Rights or Benefits

1. The “12-Month Rule”

The ANPRM proposes a “12-month rule” applicable to expenditures paid to create or enhance certain intangible rights or benefits that would eliminate capitalization under section 263(a) unless the created or enhanced intangible extends beyond the earlier of (i) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (ii) the end of the next taxable year after the expenditure. The rule would apply to prepaid items, market entry payments, amounts paid to obtain rights from a governmental agency, amounts paid to obtain or modify contract rights, amounts paid to terminate certain rights (including lease rights), amounts paid in connection with tangible property owned by another, and amounts paid in defense or perfection of title to intangible property.

The IRS and Treasury are to be commended for their intention to propose a 12-month rule. We believe that the adoption of a 12-month rule is well supported by the case law, and is
well within the IRS’s administrative authority. A 12-month rule would also greatly reduce taxpayer recordkeeping and compliance costs.

Uncertainty over the parameters of the so-called one-year or 12-month rule has existed for many years. We recommend the regulations clearly set forth rules that avoid needless controversy in the future. Thus, we recommend that the rule explicitly apply to both cash method and accrual method taxpayers and that, in the interests of simplicity, the 12-month rule be available to both types of taxpayers on the same basis.

In keeping with the intent to provide workable safe harbors and simplifying assumptions, we recommend that the proposed regulation explicitly provide that the 12-month rule applies to all situations where the useful life or benefit of the expense does not extend beyond the earlier of (i) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred. Thus, in the case of the cost of an intangible asset that otherwise qualifies for deduction under the 12-month rule, the extent to which the life or benefit of that asset extends into the taxable year succeeding the year in which the cost is incurred would never be considered to be “substantially beyond the taxable year” within the meaning of Treas. Reg. § 1.263(a)-2(a).

It is recommended that eligibility to use the 12-month rule with respect to an expense with a useful life or benefit of 12 months or less should not be predicated on the taxpayer’s GAAP treatment. As discussed elsewhere in these comments, GAAP accounting and tax accounting have different purposes, and it is often not necessary or desirable that the treatment under the two regimes be the same. Thus, we recommend that the proposed regulation explicitly state that GAAP conformity is not required for application of the 12-month rule.

Further, the proposed regulations should state that a taxpayer’s use of the 12-month rule is a method of accounting that clearly reflects income within the meaning of section 446. In other words, when a taxpayer’s use of the 12-month rule is permitted under section 263, it should be equally clear that it is permissible under the clear-reflection-of-income principles of section 446. See Thor Power Co. v. Com’r, 439 U.S. 522 (1979); Van Raden v. Com’r, 71 T.C. 1083, 1105 (1979).

Rights of Indefinite Duration: The ANPRM requests comments on how the 12-month rule might apply to expenditures paid to create or enhance rights of indefinite duration and contracts subject to termination provisions. One example posited in the ANPRM concerns the situation in which the contract rights are terminable at will without substantial penalties.

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2 See U.S. Freightways v. Com’r, 270 F.3d 1137 (7th Cir. 2001); Zaninovich v. Com’r, 616 F.2d 429 (9th Cir. 1980); see also Rev. Rul. 89-62, 1989-1 C.B. 89 (allowing deduction for costs of videocassettes with useful life of one year or less); Rev. Rul. 78-382, 1978-2 C.B. 111 (allowing deduction for cost of rental uniforms in year placed in service since most uniforms do not remain in use for 12 months); Rev. Rul. 69-81, 1969-1 C.B. 137 (allowing deduction for costs of clothing, towels, and other items with a useful life of one year or less).

3 Even the courts are divided on the existence and application of the 12-month rule under current law, as demonstrated by the recent decisions of the Tax Court and Court of Appeals for the Seventh Circuit in the U.S. Freightways case. See U.S. Freightways v. Com’r, 270 F.3d 1137 (7th Cir. 2001), rev’g and remanding, 113 T.C. 329 (1999). We agree with the analysis of the Court of Appeals for the Seventh Circuit in U.S. Freightways that the rule applies to both cash method and accrual method taxpayers.
We believe that costs of acquiring a contract right with a life of 12 months or less should not be subject to capitalization, without regard to renewal rights held by the other party. Similarly, as a result of the 12-month rule, costs that create rights of indefinite duration should not be subject to capitalization, so long as, under the explicit terms of the contract, the taxpayer’s rights can be cancelled by the other party without material penalty or other cost. A contract that is terminable at will without material penalty is essentially the same as a pure at-will arrangement. As with a contract terminable at will by the other party, the customer’s ability to walk away from the contract at minimal expense prevents the contract from having any reliable value to the taxpayer. Thus, even where the term nominally exceeds 12 months, the cost of such a contract should be deductible under the 12-month rule.

As a matter of commercial reality, most rights of long-term duration are negotiated as to their duration and are explicit as to the length and other conditions of their terms, including renewal options. Rights that can be characterized as being of indefinite duration that are potentially subject to application of the 12-month rule most likely initially have a formal term of 12 months or less with renewals at the option of the taxpayer’s customer.

The mere fact that the taxpayer entered into a contract or other arrangement that ultimately may extend beyond 12 months does not make the initial cost of acquiring that right a significant capital expenditure. Each renewal (or failure to cancel) is an independent decision by the taxpayer’s customer to avail itself of its contractual right to extend the term of the contract. Moreover, the fact that as a group taxpayer’s contracts may exhibit an average life of more than 12 months does not compel the conclusion that the costs of obtaining the contract should be capitalized. The average life of such assets is more a function of the quality of service (and related costs) provided the customer during the initial term. That is, the generalized goodwill initially created through the initial expenditure remaining after one year is insignificant compared to the increase (or decrease) in goodwill created by other activities during that period. Treating the future benefit of the initial expenditure as potentially significant one year later is inconsistent with commercial reality.

Unlike the types of property that by their nature can provide value and usefulness to a taxpayer beyond a 12-month period, a contract for the performance of services by the taxpayer

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4 Economically, these situations are indistinguishable. In fact, they are often little different from shorter fixed-term contracts that are easily renewed, such as through the customer’s continued availing itself of the taxpayer’s services. Similar issues arise under the OID rules, under the redemption premium regulations of section 305 and in connection with the determination of whether stock is nonqualified preferred stock under section 351(g). In all these situations, the rules look to rational economic behaviour by an investor to determine the tax character of the instrument.

5 We recognized that an administrable regime could also be created by requiring capitalization of acquisition costs whenever the contract has an indefinite term or a term exceeding 12 months, without regard to the customer’s ability to cancel without material penalty. Unamortized costs would be recovered when a contract is cancelled. This approach would treat economically similar situations differently and may motivate taxpayers to revamp their formal arrangements with any eye solely to tax consequences.

6 One example of this type of right is that created by cellular telephone contracts. See TAM 9813001 (requiring capitalization of commissions paid to agents to obtain customers for cellular telephone service). Typically, the cellular service provider pays a commission to the agent, which brings in the customer. If the cellular service provider enters into a contract with a customer that provides that the customer may repeatedly renew, its right to payment in return for cellular service appears to have an indefinite life.
requires active fulfillment of those obligations in exchange for the taxpayer’s right to receive income under the contract. Further, an unrelated party (the taxpayer’s customer) decides independently whether or not the contract continues beyond the initial 12-month term.

On the other hand, we do not think the 12-month rule should apply to a contract merely because the taxpayer may not or does not choose to enforce its rights to continue the contract, to impose cancellation penalties or the like. To invoke the 12-month rule, a taxpayer should not have any such rights under the contract as written. If a penalty appears on the face of the contract, but is not enforceable under applicable substantive law, the question is closer, but, taking the need for certainty into account, we do not think the 12-month rule should apply.

While some cases have required capitalization of costs related to indefinite-lived intangibles, a broader application of the “12-month rule” would best serve the ends of certainty and administrability, while causing little if any distortion in the matching of expense and income. The suggested approach shifts the focus from the nominal duration of the contract to the economic reality of whether the taxpayer gained any true expectancy.

In summary, we believe that costs of acquiring contracts should not be capitalized when (1) the initial fixed term is 12 months or less, without regard to the customer’s ability to renew, or (2) the contract by its terms may be cancelled by the customer without material penalty, regardless of the nominal length of the contract. We also recommend that regulations make clear that requirements to give notice or to return property not owned by the third party will not constitute material penalties. For all of these purposes, the contract between the parties should include all agreements and not just the formal “contract” between the parties. Thus, taxpayers could not abuse these rules with side-agreements or provisions inserted into otherwise unrelated documents.

2. Prepaid Items

The ANPRM states that, subject to a 12-month rule, the IRS and Treasury expect to propose a rule that requires capitalization of an amount prepaid for goods, services, or other benefits (such as insurance) to be received in the future. For example, a taxpayer that prepays the premium for a three-year insurance policy would be required to capitalize such amount under the rule.

We support this suggested rule. Combined with the “12-month rule”, it achieves matching, certainty, and administrability. We recommend that the regulations clarify that this rule applies only where the taxpayer acquires an enforceable right to the goods, services, or other benefits for which the prepayment was made. Please see the discussion below regarding standards for determining whether a taxpayer acquires an enforceable right.

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7 See Houston Natural Gas Corp. v. Com’r, 90 F.2d 814 (4th Cir. 1937) (requiring capitalization of costs of installing service lines and salaries of sales agents) and Fall River Gas Co. v. Com’r, 349 F.2d 515 (1st Cir. 1965) (requiring capitalization of costs of installing leased gas appliances).

8 A contract that is terminable at will without substantial penalty is essentially the same as a pure at-will arrangement. As is the case where the right created is of indefinite duration, the taxpayer’s customer’s ability to walk away from the contract at minimal expense prevents the contract from having an ascertainable life. Thus, such a contract, even where the term nominally exceeds 12 months, should not be capitalized under the 12-month rule.
3. Certain Market Entry Costs

The ANPRM states that, subject to a 12-month rule, the IRS and Treasury expect to propose a rule that requires capitalization of an amount paid to an organization to obtain or renew a membership or privilege from that organization. For example, subject to a 12-month rule, the rule would require capitalization of costs to obtain a stock trading privilege, admission to practice medicine at a hospital, and access to the multiple listing service. The rule does not contemplate requiring capitalization for costs to obtain ISO 9000 certification or similar costs.

We support this position in large part, and we suggest the proposed regulations confirm that only the costs of acquiring a right to enter a market should be capitalized. Well-established examples of market entry fees include liquor licenses, initiation fees to obtain a seat on a stock exchange, and bar admission fees. In each of these cases, the intangible asset in question was truly a legal or contractual prerequisite and an essential element of the taxpayer’s business.

Market entry payments that create intangible assets should be distinguished, however, from other types of payments that merely enhance or facilitate the conduct of the taxpayer’s business without giving rise to legal rights. Examples of this latter type of payment include the costs to obtain various recommendations and approvals like a J.D. Power rating or an ISO 9000 certification. Unlike licenses and permits, these types of certifications do not enable the taxpayer that obtains them to engage in business activities such as the manufacture of goods or the provision of services; the certifications merely provide notification to third parties that the taxpayer has met certain standards set by the awarder of the certification. Thus, these types of payments are more akin to advertising and marketing costs. Like generalized goodwill, they may generate more business for the taxpayer, but they do not enable the taxpayer to conduct that business.

The proposed regulations should preserve this distinction between costs that facilitate the conduct of business activities and costs that enable the entry into a market. Further, we suggest the proposed regulations incorporate, by example or otherwise, the conclusions set forth in Rev. Rul. 2000-4, 2000-1 C.B. 331, that the costs of obtaining, maintaining, and renewing ISO 9000 certification are deductible.

4. Costs of Obtaining Rights from a Governmental Agency

The ANPRM provides that, subject to a 12-month rule, the IRS and Treasury expect to propose a rule that requires capitalization of an amount paid to a governmental agency for a trade name, trademark, copyright, license, permit, or other right granted by that governmental agency.

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9 See, e.g., Nachman v. Com’r, 191 F.2d 934 (5th Cir. 1951).


11 See, e.g., Sharon v. Com’r, 66 T.C. 515 (1976), aff’d, 591 F.2d 1273 (9th Cir. 1978).

12 As discussed below, the capitalized cost should be recovered over the legal duration of the right or (if there is none) over any default recovery period established by the regulations.
For example, under the rule, a restaurant would be required to capitalize the amount paid to a state to obtain a license to serve alcoholic beverages that is valid indefinitely.

We agree with this proposed position. The amounts subject to capitalization are both clearly identifiable and relate to legal rights with a significant future benefit.\(^\text{13}\)

5. Amounts Paid to Obtain or Modify Contract Rights

The ANPRM provides that, subject to a 12-month rule, the IRS and Treasury expect to propose a rule that requires capitalization of amounts in excess of a specified dollar amount (\(e.g., \$5,000\)) paid to another person to induce that 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, licenses to use intangible property, customer contracts and supplier contracts. The IRS and Treasury request comments on whether other standards would be more appropriate for determining whether expenditures related to the creation or enhancement of contractual rights should be capitalized.

We agree that it is appropriate to capitalize amounts paid to induce another party to enter into, renew or renegotiate an agreement that produces contract rights enforceable by the taxpayer. We recommend adding insurance contracts to the list in the ANPRM of contracts that create rights enforceable by the parties.

The ANPRM states that this rule would not require a taxpayer to capitalize a payment that does not create enforceable contract rights, but, for example, merely creates an expectation that a customer or supplier will maintain its business relationship with the taxpayer. \(^{\text{See, e.g., Van Idersteine Co. v. Com'r, 261 F.2d 211 (2d Cir. 1958).}}\) We recommend that the regulations provide clear rules for distinguishing between contracts that create legally enforceable rights and contracts that merely create expectations. Specifically, it should be made clear that a prior course of dealing, motivation of the other party due to mutual benefit, or a moral expectation do not rise to this level unless they are legally enforceable. \(^{\text{14}}\) This approach is consistent with the

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\(^{\text{13}}\) As discussed below, the capitalized cost should be recovered over the legal duration of the right or (if there is none) over any default recovery period established by the regulations.

\(^{\text{14}}\) The distinction between contracts that create enforceable rights and contracts that create mere expectations was specifically addressed in \(\text{Briarcliff Candy Corp. v. Com'r, 475 F.2d 775 (2d Cir. 1973).}\) In \(\text{Briarcliff,}\) the taxpayer incurred costs to create a new distribution network in the suburbs under which each store owner agreed to set aside a space in the store for refrigerated display and storage counters at his own expense to be "exclusively devoted" to the sale of the taxpayer's candies and to use his best efforts to sell these candies to his customers. The court concluded that the meagerness of the taxpayer's rights under the contracts made them only marginally enforceable. The agreements gave the taxpayer no property interest whatever in the display case and storage area or advertising features and no enforceable right in regards to a store owner's agreement to use his best efforts in selling the taxpayer's products. In effect, by these contracts, the taxpayer acquired little more than an expectation or hope of future sales, and thus, the costs incurred to get these contracts were deductible.

The court in \(\text{Van Idersteine Co.}\) reached a similar conclusion. In that case, the taxpayer paid a lump sum amount to several suppliers to obtain raw materials in a large and steady volume. The taxpayer acquired no enforceable contract rights and obtained no rights extending beyond the taxable year of payment; the suppliers could stop selling to taxpayer at any time. All the taxpayer acquired was an expectation or hope that it would be preferred over other possible purchasers, and thus, the court held that the payments were deductible.
suggested approach to contracts of indefinite duration.

In the case of a contract for the purchase or sale of goods or services, we recommend the regulations provide that a taxpayer acquires an enforceable contract right only if the taxpayer acquires a right under the contract to buy or sell a fixed or minimum amount of goods or services for a fixed price or for a price that can be determined by a formula. Similarly, we believe the regulations should require capitalization (subject to the 12-month rule and de minimis rule) of expenditures to secure a legally binding obligation of another to refrain from purchasing or selling the products of others.

6. Amounts Paid to Terminate Certain Contracts

Subject to the 12-month rule, the IRS and Treasury expect to propose a rule that requires capitalization of an amount paid by a lessor to a lessee to induce the lessee to terminate a lease of real or tangible personal property or by a taxpayer to terminate a contract that grants another person the exclusive right to conduct business in a defined geographic area. For example, under the rule, a lessor that pays a lessee to terminate a lease of real property with a remaining term of 24 months would be required to capitalize such payments. See, e.g., Peerless Weighing and Vending Machine Corp. v. Com’r, 52 T.C. 850 (1969). As a further example, where a taxpayer grants another person the exclusive right to develop the taxpayer's motel chain in four states, and the taxpayer later pays that other person to terminate this right at a time when the remaining useful life of the right is 5 years, the taxpayer would be required to capitalize the termination payment under the rule. See Rodeway Inns of America v. Com’r, 63 T.C. 414 (1974).

We agree with this proposed position. To reduce confusion and controversy, however, we recommend the regulations make clear that, except in the circumstances described above, payments to terminate a contract are deductible (and that the payment constitutes an ordinary deduction, not a capital loss). This result is consistent with the principle of income matching, since no further income can be expected from the terminated contract, unless the costs are actually an inducement for the counterparty to enter a new arrangement. The resulting rules are clear, effective, and prevent taxpayers from inappropriately accelerating deductions through artificial contract terminations.

In some circumstances, it may be necessary to determine whether a payment is made to terminate a contract (deductible) or to induce the counterparty to enter into a new arrangement (capitalized). Courts have generally allowed taxpayers to deduct currently amounts paid to terminate burdensome contracts. On the other hand, when a lease termination payment is part

While these determinations may be required to be made under disparate or untested state law, this is not atypical of any inquiry into the legal rights of a taxpayer in a tax-related dispute.

15 See, e.g., Capitol Indemnity Ins. Co. v. Com’r, 237 F.2d 901, 903 (7th Cir. 1956) (amounts incurred by taxpayer to free itself from an unprofitable agency contract were deductible); Montana Power Co. v. U.S., 171 F. Supp. 943 (Ct. Cl. 1959) (cash paid and the fair market value of stock surrendered to relieve the taxpayer of its obligation under supply contract was deductible business expense); Stuart Co. v. Com’r, T.C. Memo ¶ 50,171, aff’d, 195 F.2d 176 (9th Cir. 1952) (an amount allocable to the cancellation of an onerous supply contract was deductible as an ordinary and necessary business expense); Olympia Harbor Lumber Co. v. Com’r, 30 B.T.A. 114 (1934), aff’d, 79 F.2d 394 (9th Cir. 1935) (amount paid to terminate an unsatisfactory waste disposal contract was a currently deductible business expense).
of a new lease of property from the same lessor, courts have required capitalization over the life of the new lease. It may be helpful to clarify that a payment to terminate a contract is not treated as a payment to modify an existing contract or enter into a new contract unless the termination is conditioned on the receipt by the taxpayer of new property or other rights from the person receiving the payment. This clarifies that a taxpayer should be able to deduct payments to terminate a contract with one party in order to enter into new arrangements with another party.

7. Amounts Paid in Connection with Tangible Property Owned by Another

Subject to the 12-month rule, the IRS and Treasury expect to propose a rule that requires capitalization of amounts in excess of a specified dollar amount 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 of the tangible property results in the type of intangible future benefit to the taxpayer for which capitalization is appropriate. This rule would apply even though there is no contractual relationship between the taxpayer and the other person. This rule is intended to require capitalization of expenditures that produce intangible future benefits similar to those that were in issue in Kauai Terminal Ltd. v. Commissioner, 36 B.T.A. 893 (1937). The IRS and Treasury Department request comments on standards that can be established to ensure that the expenditures described in this rule result in the type of future benefits that are similar to those in Kauai Terminal and therefore should be capitalized.

While we support this rule, we believe that, if it is not limited to those types of benefits obtained in Kauai Terminal, the rule will be interpreted so broadly that it will result in perpetuating uncertainty and controversy.

The regulations should limit application of the rule to amounts (in excess of a specified dollar amount) paid to facilitate the acquisition, production, or installation of tangible property that is owned by a person other than the taxpayer only where, as in Kauai Terminal, the

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16 See Pig & Whistle Co. v. Com’r, 9 B.T.A. 668 (1927); Phil Gluckstern’s, Inc. v. Com’r, 15 T.C.M. 41 (1956) (both requiring capitalization of termination payments that facilitated a new lease of the same property to the taxpayer). In U.S. Bancorp v. Com’r, 111 T.C. No. 10 (1998), the Tax Court addressed a situation that fell between these two extremes. The taxpayer paid a termination charge or “rollover fee” to a lessor of computer equipment in order to terminate the lease of one computer, conditioned on the lease of a new computer from the same lessor. The court held that the amount must be capitalized because it was “both closer to and qualitatively more similar to the modification of a lease than to a simple termination.”

17 See, e.g., PLR 9615028 (permitting deduction of payments made to buyout an onerous power purchase contract, even though the same counterparty could require purchase of power under unmodified existing contracts); PLR 199913032 (permitting deduction of cash and value of stock paid to terminate onerous power purchase agreements because there was no condition that the taxpayer enter into any new agreements, citing U.S. Bancorp, above).

18 In Kauai Terminal, the taxpayer ran a shipping business from a port that had no natural harbor. To prevent flooding, the United States government and the taxpayer jointly paid the cost of a new breakwater, with the government holding title to the breakwater. The Board of Tax Appeals held that the taxpayer's cost of the breakwater must be capitalized. In so holding, the Board stated: "So far as the taxpayer was concerned, although it did not own the breakwater and had no tangible capital asset as a result of its expenditure, the benefit resulting from the expenditure was as desirable as if the breakwater had become its own (or perhaps more so, since the Government was to carry the burden of maintenance)."
taxpayer's benefit resulting from the expenditure is of the same magnitude and nature as if the tangible property were owned by the taxpayer.\textsuperscript{19} Thus, for example, a taxpayer would not be required to capitalize amounts contributed to an urban improvement effort that might benefit its business as well as other businesses in the area, but would be required to capitalize amounts paid to a municipality (whether styled as improvement taxes or otherwise) to build a sidewalk in front of its business, even though the sidewalk might be technically owned by the municipality.

The regulations should also provide that the rule does not apply in cases where the amount paid by the taxpayer directly facilitates the provision of goods or services to the taxpayer.\textsuperscript{20} The costs in that situation should be tested under the rules for payments to obtain or modify contract rights. If they give rise to legally enforceable rights, the costs should be capitalized. Because these payments are connected to a specific identifiable relationship with the taxpayer, they should be tested under rules applicable to that relationship rather than the rules that apply to the unusual circumstances of \textit{Kauai Terminal}.

### 8. Amounts Paid to Defend or Perfect Title to Intangible Property

Subject to the 12-month rule, the IRS and Treasury expect to propose a rule that requires capitalization of amounts paid to defend or perfect title to intangible property. For example, under the rule, if a taxpayer and another person both claim title to a particular trademark, the taxpayer must capitalize any amount paid to the other person for relinquishment of such claim. \textit{See, e.g., J.I. Case Company v. United States}, 32 F. Supp. 754 (Ct. Cl. 1940).

We agree with this position, so long as capitalization is required only when the adverse party asserts a legal claim to otherwise legally enforceable rights of the taxpayer, including rights of the general public in the case of a failed trademark or copyright. In contrast, where the taxpayer is asserting its rights (such as under a patent or copyright) to constrain the conduct of another, the taxpayer is not defending the intangible but rather using it. This can lead to difficult line-drawing, since the common defense to the assertion of this sort of right is that the intangible right is invalid. We believe much of this uncertainty can be eliminated with a bright-line test that permits deduction when a focus of the lawsuit is specific conduct by another party that putatively violates the intangible rights. When the original focus of the lawsuit (or other action) is \textit{merely} the validity of the intangible right, related expenditures should be capitalized.\textsuperscript{21}

\textsuperscript{19} \textit{See, e.g.}, Rev. Rul. 69-229, 1969-1 C.B. 86 (costs incurred by a railroad company for the construction of a state-owned highway bridge over its tracks were capital expenditures amortizable over the estimated time the bridge would be in use where the bridge provided the taxpayer a safe and efficient new railroad and highway crossing); Rev. Rul. 68-607, C.B. 1968-2 (costs incurred for improvements made on a state-owned highway right-of-way to provide ingress and egress to the taxpayer's shopping center developed on leased land were capital expenditures).

\textsuperscript{20} \textit{See} GCM 39663 (Oct. 14, 1986) (an advance payment made by a manufacturer to a common carrier freight railroad to build a side track from the manufacturer's plant to the railroad's main track in exchange for the railroad's promise to ship the manufacturer's goods at a discounted shipping fee were payments for future services and, accordingly, a ratable share of the advance payment was deductible each time a shipment was made).

\textsuperscript{21} Thus, legal costs incurred in a declaratory judgment merely defending a copyright or patent must be capitalized, but costs to enforce patent rights are deductible, even though the defendant may argue as a defense that the patent is invalid. This creates a coherent result, since if the patent is upheld, the primary outcome is determining whether infringement occurred, and if the patent is held invalid, the taxpayer would have an immediate loss deduction of the amounts capitalized.
II. Cost of Acquiring, Creating, Restructuring, or Reorganizing a Business Entity

A. The ANPRM

The IRS and Treasury expect to propose a rule that would require a taxpayer to capitalize transaction costs that facilitate the taxpayer’s acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of section 1060(c), or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization (collectively referred to herein as “Corporate Transaction Costs”). However, the proposed rule would not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), fixed overhead (e.g., rent, utilities and depreciation), or costs that do not exceed a specified dollar amount, such as $5,000.

The IRS and Treasury are considering alternative approaches to minimize uncertainty and to ease the administrative burden of accounting for transaction costs. For example, the rules could allow a deduction for all employee compensation (including bonuses and commissions that are paid with respect to the transaction) based on whether the transaction is regular or recurring, or follow the financial or regulatory accounting treatment of the transaction. The IRS and Treasury request comments on whether the recurring or nonrecurring nature of a transaction is an appropriate consideration in determining whether an expenditure to facilitate the transaction must be capitalized under Section 263(a) and, if so, what criteria should be applied in distinguishing between recurring and nonrecurring transactions. In addition, the IRS and Treasury request comments on whether a taxpayer’s treatment of transaction costs for financial or regulatory accounting purposes should be taken into account when developing simplifying assumptions.

The rule would require a corporate taxpayer to capitalize legal fees in excess of the threshold dollar amount paid to its outside counsel to facilitate an acquisition of all of the taxpayer’s outstanding stock by an acquirer. However, the rule would not require capitalization of the portion of officers’ salaries that is allocable to time spent by the officers negotiating the acquisition. The rule also would require the capitalization of post-acquisition integration costs or severance payments made to employees as a result of an acquisition transaction because such costs do not facilitate the acquisition.

B. Comments

These issues are of particular importance because of the size of the expenditures and the variety of circumstances under which they arise. This is the issue at the heart of INDOPCO in which the Supreme Court required capitalization of a corporate target’s expenditures related to its acquisition. Subsequently, the Seventh Circuit held in A.E. Staley Manufacturing Co. v. 22 The Court rejected the taxpayer’s argument that “creation or enhancement of an asset” is a prerequisite to capitalization, stating that “the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure.” The Court denied the current deduction because “the purpose for which the expenditure is made has to do with the corporation’s operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year” (quoting General Bancshares Corp. v. Com’r, 326 F.2d 712 (8th Cir. 1964) cert. denied 379 U.S.832). The Court explained that while the mere presence of an incidental future benefit “may not
**Commissioner,** 119 F.3d 482 (7th Cir. 1997) that costs of a hostile takeover defense need not be capitalized. In **Wells Fargo & Co. v. Commissioner,** 224 F.3d 874 (8th Cir. 2000), the Eighth Circuit declined to capitalize any internal costs (such as compensation) with regard to a target’s acquisition. Further, the court endorsed the general approach of Rev. Rul. 99-23, 1999-1 C.B. 998, and permitted deduction of costs prior to the decision of whether to enter into a transaction and which party to transact with.

We support the general approach suggested by the ANPRM. That is, all external Corporate Transaction Costs would be capitalized, subject to a specified de minimis rule (such as $5,000). Internal costs would not be capitalized, except commissions and bonuses directly and explicitly related to the transaction. We believe this approach capitalizes appropriate costs, while providing taxpayers (and examining agents) with clear, workable rules. We submit the following additional comments on related issues.

**Scope:** We believe these rules should apply without regard to whether the transaction is “regular and recurring.” It is important to note that this is not the same question as whether certain costs are regular and recurring, discussed below. These transactions are inherently capital in nature and give rise to the sort of significant future benefit the Supreme Court found worthy of capitalization in **INDOPCO.** This case also compels the conclusion that it does not matter whether the costs are incurred by the target or by the acquirer. Further, the “regular and warrant capitalization, a taxpayer’s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.” The Court concluded by stating that “the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such.”

23 In **Staley,** the taxpayer was the target of a hostile takeover attempt that eventually proved successful. To help prevent the hostile takeover, the taxpayer hired investment bankers and other professionals. While efforts to avoid the hostile takeover were unsuccessful, the Seventh Circuit found that most of the fees paid to the investment bankers and other professionals were paid to defend “against an unwanted acquisition in an effort to maintain and protect an established business.” Because the fees were paid by the taxpayer to defend its business and its corporate policy, the court held they are deductible under Section 162(a).

24 In **Wells Fargo,** the taxpayer was the target of a friendly acquisition. The two issues before the court were: (1) whether the salary expenses paid to the taxpayer’s employees were deductible or whether they had to be capitalized as part of the acquisition costs and (2) what portion of the legal fees paid to the taxpayer’s attorneys to investigate the transaction are deductible.

With respect to the first issue, the court found that there was no increase in the salaries attributable to the acquisition and that the employees would have been paid the salaries if the acquisition had not occurred. The court therefore held that the salary expenses originated from the employment relationship between the taxpayer and its employees and were deductible. With respect to the second issue, the court held that any investigatory expenses which postdate the “final decision” to acquire a business must be capitalized. The court cited, but did not adopt, Rev. Rul. 99-23 in holding that the facts of a particular transaction determine whether the investigatory costs may be capitalized.

25 In Rev. Rul. 99-23, the IRS created a test to determine whether expenditures qualify as investigatory costs that are eligible for amortization as start-up expenditures under Section 195 or must be capitalized. The IRS ruled that expenditures incurred in the course of a general search for, or investigation of, an active trade or business in order to determine whether to enter a new business and which new business to enter (the “whether and which decisions”) qualify as investigatory costs that are eligible for amortization as start-up expenditures under Section 195. On the other hand, costs incurred to facilitate the consummation of an acquisition or incurred in the attempt to acquire a specific business are acquisition costs that must be capitalized.
recurring” test is difficult to apply, leading to uncertainty and disparity in taxpayer treatment.

Costs to defend against a hostile action by another person should not be capitalized. Defending a hostile action is distinguishable from “defending title” to property, trademarks, etc., because in those cases the taxpayer is affirming and defining its rights.26 So long as a corporation is averse to a takeover, it is attempting to maintain the status quo and is not seeking an additional future benefit. This conclusion works well with the “whether and which” test below, since the decision or recommendation of the Board of Directors will clearly indicate whether it supports the takeover, and prior to that time costs need not be capitalized in either case. Thus, the question whether a takeover is “hostile” becomes moot, as well as the identity of the nominal target or acquiror.

Time Capitalization Begins: We recommend that the “whether and which” test of Rev. Rul. 99-23 be incorporated into the regulations, with further clarification of when this point occurs. We suggest that, in the case of corporations, this has taken place when the transaction has received all necessary approval under applicable provisions of the controlling corporate governance documents to proceed with the transaction or to recommend the transaction to shareholders. For most corporate mergers, acquisitions, and reorganizations, this will occur when the Board of Directors approves the transaction.27

In the case of corporate borrowings, the “whether and which” test should be met when the required level of internal corporate approval has occurred, which may be by action of a Board Committee, Financial Officer, or designated employee.

Similar rules should apply in the case of other entities, such as trusts and partnerships. The key inquiry should be whether the entity has committed itself to the particular course of action. Thus, the corporate rules would apply in the case of S corporations or limited liability companies, whether taxed as a corporation or as a partnership, when the scheme of corporate governance is similar. In the case of other entities (such as those taxed as a partnership), the “whether and which” threshold should be crossed when the entity has sufficiently obligated itself so that abandonment of the transaction would impose on the entity (or its controlling partners) a penalty or other liability to another person (including other partners). This objective test is preferable to using a standard that inquires into the subjective intent of the entity or its principals.

We recommend an appropriate anti-abuse rule address artificial delays in formal approval that (i) are designed principally to permit deduction of additional costs and (ii) lack other business causes or considerations.

Costs to be Capitalized: We believe the proposed rule correctly attempts to limit capitalization to costs that “facilitate” the transaction. This appears to be derived from the Wells Fargo decision that compensation must be directly related to a capital transaction before it is required to be capitalized. Capitalization should be limited to those costs that directly relate to a

26 The proper analogy is an action in trespass rather than an action to quiet title. The taxpayer is enforcing its existing rights rather than seeking to affirm and define rights that it may or may not have.

27 Thus, a mere letter of intent, which is a commitment to negotiate, is not sufficient, even if it is formally approved by the Board of Directors.
capital transaction, instead of being so broad as to include all costs that tangentially facilitate the transaction.

Many ordinary and necessary costs of a trade or business may in some way facilitate a capital transaction, but not be directly related to the transaction. Therefore, the proposed rule correctly excludes employee compensation and other ordinary internal costs (except perhaps for bonuses or commissions that are paid with respect to the transaction). We recognize that this result could be credibly criticized as disproportionately beneficial to larger companies. Even in larger companies, however, internal staff typically perform a variety of regular and recurring tasks not related to acquisitions. Ultimately, this rule would rest on administrative concerns as much as the pure theory of capitalization.

We believe capitalized costs that “facilitate” the transaction should also exclude costs paid to outside professionals if the costs are not directly related to the capital transaction. For example, costs to explore alternatives to the transaction should not be capitalized, while costs to execute the transaction should be capitalized.

We believe internal commissions and bonuses directly and explicitly related to the transaction should be capitalized, subject to the de minimis rule. These are readily ascertainable and not so numerous as to cause undue burden in light of their potential magnitude. No other internal costs would be required to be capitalized. By and large, these other costs would have been incurred without regard to the Corporate Transaction.

We recommend that amounts paid to other taxpayers, such as investment bankers, be apportioned based on the work performed before and after the “whether and which” decision (measured in any reasonable manner, such as hours expended). Fees contingent on the closing of the transaction would be subject to this rule, even though no amount would have been paid but for the transaction, since such provisions are primarily an incentive for effective services and a hedge against excessive costs when no future benefit is gained.28

Cost Recovery Period: Much of the controversy in this area can be mitigated through promulgation of reasonable cost recovery periods for those costs that are required to be capitalized. In the case of the acquisition of a security, option, any other financial interest described in section 197(e)(1), or any evidence of indebtedness, we believe the capitalized transaction costs should be added to the basis of that asset. When not covered by that rule, we believe that costs should be amortized ratably over the life of any intangible asset that has an ascertainable useful life. In the case of a corporate borrowing for a fixed term, when prepayment or redemption rights rise to multiple lives, use of the longest life appears fair, so long as unamortized capitalized costs can be deducted if the instrument is terminated earlier. As an alternative, taxpayers should be able to elect amortization based on the percentage of principal outstanding. The “12-month” rule would apply, obviating capitalization in the case of short-term commercial paper.

In all other cases, such as changes in the taxpayer’s equity with no definite term, we endorse recovery over a specified default period, which need not be the same default period that

28 Arguably, a rule that required capitalization of all success-based fees would be easier to administer, since no proration would be required. We do not believe it is a significant burden, however, since each of the necessary factual determinations must be made in any case, and all that remains is simple arithmetic. Further, adoption of a per se capitalization rule would distort the market and pricing of these services.
is provided for other intangible assets. For example, ratable cost recovery over either 5 or 15 years would provide a workable, bright-line accounting treatment for these costs. While recovery over 15 years would be consistent with the statutory recovery period of section 197 for the intangibles acquired in a business acquisition, those section 197 intangibles do not relate to the capital structure of the entity. Instead, they relate to business assets affecting the operation of the business. Arguably, costs to alter an entity’s capital structure are more akin to the organizational costs of partnerships and corporations, which are permitted to be amortized over 5 years under sections 709 and 248, respectively. In any case, the adoption of an amortization period will further the purpose of reducing controversy, since resolution of any dispute is more workable when the alternative to deduction is less extreme. We believe either recovery period to be both supportable and (in the context of the other proposed guidance of the ANPRM) a significant improvement in the administration of tax accounting for these costs.

Post-Acquisition Integration Costs: The proposed regulations should provide that business integration costs are not required to be capitalized as such. Taxpayers typically incur these costs after a merger or acquisition in order to consolidate and integrate the two sets of business operations. These costs generally include management compensation, costs to retain key employees, severance pay, integration of records and information systems, and other costs necessary to eliminate or reduce unnecessary and duplicative locations, departments, and business equipment, such as moving and relocation costs and contract termination costs. As a general matter, these costs do not facilitate the merger or acquisition that necessitates them and therefore should not be capitalized on that basis. Rather, these costs typically reduce future operating costs or increase future operating efficiencies; neither of those types of future benefits is a ground for capitalization either, as has been previously recognized by the IRS.

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29 On the other hand, a 15-year amortization period would integrate better in the case of stock acquisitions treated as asset purchases. See, e.g., I.R.C. § 338(h)(10).

30 This is not to say that business integration costs are always deductible. Instead, they should be tested under the rules without regard to the fact that they followed a business acquisition. For example, a 5-year license to operate in the name of a newly integrated and renamed business unit would be capitalized over the life of the license. Similarly, the payment of contingent liabilities assumed by a purchaser may give rise to additional purchase price rather than immediate deductions. See Illinois Tool Works, Inc. v. Com’r, 117 T.C. 39 (2001) (payment of seller’s patent infringement liability is a cost of acquiring assets that must be capitalized); David R. Webb Co. v. Com’r, 708 F.2d 1254 (7th Cir. 1983), aff’g 77 T.C. 1134 (1981); but see TAM 9721002 (severance costs following asset acquisition under section 338(h)(10) may be deducted).

31 Rev. Rul. 94-77, 1994-2 C.B. 19, holds that severance payments paid to employees in connection with a business downsizing are generally deductible. Using an origin of the claim type analysis, the Service properly recognized that although such severance payments may produce some future benefits such as reducing operating costs and increasing operating efficiencies, the payments principally relate to previously rendered services of the terminated employees. The ruling leaves open the question of the tax treatment of severance payments made as part of the acquisition of a business.

Several technical advice memoranda issued after the revenue ruling was published clarified that severance payments made as a result of a merger or acquisition are also deductible. For example, in TAM 9721002, the Service held that severance payments made as a result of a stock purchase of a target corporation that was treated as an asset acquisition pursuant to §§ 338(g) and 338(h)(10) were deductible. The Service noted a deductible expense is not converted into a capital expenditure solely because the expense is incurred in a corporate acquisition. Rather, the nature of the payment should be determined under the “origin of the claim” doctrine established by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963). In this case, the Service reasoned that although the severance payments were coincidental with the buyer’s acquisition of the target corporation, the severance payments had their
The same analysis is appropriate for other types of business integration costs that are incurred after the merger or acquisition is completed. A merger or other form of reorganization affects the capital structure of the corporation and is complete once the legal documentation required for the transaction has been submitted and approved. Business integration costs do not facilitate the merger itself even though they help implement the merger by bringing about an integration of the two businesses. These costs affect the corporations’ operating assets, not its capital structure. Although these costs, like the severance payments in Rev. Rul. 94-77, may reduce future operating costs and increase future operating efficiencies, the IRS has taken the position that these types of benefits, without more, do not require capitalization. Moreover, as with severance pay, these types of costs principally relate to the taxpayer’s past business operations.

If the acquisition of a business were to occur through an acquisition of assets, it is even clearer that the post-acquisition business integration costs should not be capitalized by reason of the acquisition. In this case, there is no change in the acquiring corporation’s capital structure, since the corporation has merely increased its operating assets. If the corporation incurs costs to dispose of some of the assets after the acquisition, there is no future benefit to the corporation other than possible cost reduction. If the corporation incurs other costs intended to reduce duplication resulting from the acquisition or to focus future operations, these costs would increase future operating efficiencies or reduce future operating costs, which are not the types of future benefits that require capitalization.

III. Other Areas of Comment

A. Book-Tax Conformity Is Not Workable.

The IRS and Treasury are considering alternative approaches to minimize uncertainty and to ease the administrative burden of accounting for transaction costs. In the ANPRM, the IRS and Treasury request comments on whether a taxpayer’s treatment of transaction costs for financial or regulatory accounting purposes should be taken into account when developing simplifying assumptions.

We believe that financial or regulatory accounting treatment of costs should not determine the proper capitalization treatment of costs for tax purposes. This is not to say to

origin in the buyer’s decision to terminate the target corporation’s employees. While the acquisition may have been the catalyst for the employees’ receipt of the severance payments, the acquisition itself was not the basis for the payments.

Similarly, in TAM 9731001, the Service held that additional amounts of severance payments that the acquiring corporation agreed, as part of the merger and acquisition agreement, to pay to key employees who continued to work for the acquired company after the merger were deductible. The Service rejected the field’s assertion that the origin of the payments was the purchase of the target corporation’s stock. It noted that although it was clear that the increase in the amount of the severance payments was coincidental to the merger and was motivated by the taxpayer’s desire that the merged business operations integrate successfully, the additional severance payments had their origin in the taxpayer’s post-merger employment relationship with its employees.

32 See Rev. Rul. 95-32, 1995-1 C.B. 8 (deductibility of demand-side management costs); PLR 199913032 (“both the courts and the Internal Revenue Service have maintained that amounts paid solely to reduce or eliminate future costs are also deductible”); see also T.J. Enterprises, Inc. v. Com’r, 101 T.C. 581 (1993).
financial or regulatory accounting is never relevant, but it should not control or determine the tax accounting.

In general, reliance on generally accepted financial accounting principles as a litmus test for the appropriate tax accounting treatment of income and expenses has been rejected. While a pure and universal GAAP-tax conformity rule would on the surface appear to be administrable (at least for those taxpayers that are required to prepare financial or regulatory statements in conformity with GAAP), imposing a conformity rule only to capitalization under section 263(a) would cause more problems than it would solve. Given the large number of other areas in which tax and GAAP treatment otherwise vary, taxpayers (and IRS audit) would be forced to delve into the details of the financial accounting. For example, GAAP accounts would have to be examined to determine the extent to which they contain items controlled by other Code sections, such as sections 263A, 274 and 197.

A GAAP-tax conformity rule would undoubtedly produce significant inconsistency in the treatment of similar costs among similarly situated taxpayers. Some businesses, including large privately held businesses, are not required to prepare financial statements in conformity with GAAP, although in some cases they must do so for credit purposes. In any event, they have even more flexibility in the reporting of items than is already inherent within GAAP. Other businesses are subject to a variety of regulatory reporting regimes, each of which have different accounting rules (e.g., the insurance industry, public utilities, and commercial banking).

In addition, GAAP provides an insufficient amount of guidance to address many situations and provides significant flexibility and choice in the treatment of items where there is specific guidance. Further, GAAP accounting has a materiality threshold that varies among taxpayers.

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33 For example, when an identical factual determination must be made for both tax and financial accounting purposes (such as the fair market value of property), the taxpayer’s conclusion for accounting purposes may be relevant in determining the reasonableness of the amount determined for tax purposes. Even in these instances, however, one must be careful that the inquiries are identical or else adjust one’s conclusions based on any differences in the standards.

34 The Supreme Court in *Thor Power Tool Co. v. Com'r*, 439 U.S. 522 (1979), enumerated the following reasons for rejecting the use of financial accounting principles to measure taxable income:

Financial accounting and tax accounting have different objectives: The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others interested, and the major responsibility of the accountant is to protect these parties from being misled, whereas the primary goal of the income tax system is the equitable collection of revenue and the major responsibility of the IRS is to protect the fisc.

GAAP rules often lead to multiple interpretations and are not applied consistently among all companies: Accountants have long recognized that ‘generally accepted accounting principles’ are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions; GAAP tolerates a range of ‘reasonable’ treatments, leaving the choice among alternatives to management.

GAAP rules tend to be conservative with the result that current expensing is favored over capitalization: Financial accounting has as its foundation the principle of conservatism, with its corollary that possible errors in measurement should be in the direction of understatement rather than overstatement of net income and net assets.

35 One example is the treatment of loan and lease origination costs pursuant to Statement of Financial Accounting Standards 91. SFAS 91 provides for the capitalization of certain costs of originating loans and leases. In
In the context of business acquisitions and reorganizations, the GAAP treatment of specific transaction costs often depends on how the overall transaction is treated for GAAP purposes, which may deviate considerably from the proper tax treatment of the transaction. For example, under GAAP, purchase accounting treatment (which is analogous to a taxable asset acquisition) is now mandatory for all business acquisitions and pooling-of-interests treatment (which is analogous to a nontaxable reorganization) is now prohibited. The tax treatment of business acquisitions still varies depending on the form of the transaction, such as whether it is taxable and whether it deals with stock or assets. Further, the period of cost recovery may differ even if the transaction is a taxable asset acquisition because of the requirements of section 1060 and section 197. A GAAP-tax conformity rule that looks to GAAP for capitalization only, but does not rely on GAAP for purposes of cost recovery would therefore not achieve much in the way of simplification. Looking to GAAP for both capitalization and cost recovery would likely distort income because the treatment may bear little, if any, relationship to the tax treatment of the transaction. Because transaction costs in this context can be very significant and extraordinary, we question whether the uncertain simplification benefits of a book-tax conformity rule outweigh the potential for income distortion.

A broad-based GAAP-tax conformity rule for transaction costs would also shift the Treasury’s rulemaking authority to other entities that have differing ends in mind. Further, the GAAP treatment of items are often periodically studied and revised to take into account changes in financial reporting policies. When financial accounting rules change, difficult issues arise regarding whether taxpayers must likewise change their tax accounting practices and how to implement the change.\(^{37}\) (Financial accounting does not have a precise corollary to the adjustment required by section 481.) Having the treatment of costs change for tax purposes based on these shifts in financial reporting policy rather than tax policy is not consistent with sound tax administration.

For these reasons, we do not believe a taxpayer’s book treatment of expenditures should determine their proper treatment for federal income tax purposes.

**B. Current Rules Should Continue to Govern Amounts Paid to Acquire Software**

application, there are wide differences in the application of SFAS 91. Some businesses, including financial institutions, do not capitalize any costs, and among those businesses that do capitalize costs, the types of costs that are capitalized vary greatly. All of these businesses, however, are considered to be in conformity with GAAP.

\(^{36}\) GAAP has a materiality threshold for nearly everything. At the end of every Statement of Financial Accounting Standards, highlighted in a box, are the words: “The provisions of this statement need not be applied to immaterial items.” That which is considered material for one company is not material to another, and that which is material in one reporting period may not be in another. In practice, GAAP tolerates wide variations in practice. The consequence of having an item be considered immaterial is that the correct treatment of that item is not even evaluated, thereby making it impossible for the IRS and Treasury to even weigh the benefits of administrability against the potential for income distortion.

\(^{37}\) At present, financial reporting bodies are in the midst of overhauling financial reporting rules in the wake of the Enron controversy. Adding a GAAP-tax conformity rule to the mix not only would create a distraction that would complicate the orderly and efficient completion of that task, but would cause more rather than less uncertainty regarding the tax treatment of items because the new rules have not yet been formulated.
The IRS and Treasury request comments on rules and principles that should be used to distinguish acquired software from developed software and the administrability of those rules and principles.

The IRS policy regarding the tax treatment of costs of acquiring or developing software currently is set forth in Rev. Proc. 2000-50, 2000-2 C.B. 601. The costs of acquiring software generally must be capitalized. On the other hand, costs of developing software generally may be either deducted as incurred or capitalized and amortized over a stated period so long as the taxpayer uses the same method on a consistent basis. The Revenue Procedure is grounded not only in principles of capitalization, but also takes into account that the “costs of developing computer software . . . in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 as to warrant similar accounting treatment.”

We believe these rules should be continued and recommend their inclusion in the proposed regulations.

There appears to be little controversy between taxpayers and the IRS in cases where the taxpayer's employees develop software. The controversy has existed where the taxpayer uses a third party to develop or assist in developing the software. Taxpayers frequently contract with third parties to provide software development services. These contracts may involve the development of new software or the modification of existing software. In the latter case, the modifications frequently are so substantial that the resulting product is effectively new software. In both cases, there is the risk that the final product will not function to enable the taxpayer to achieve the results that caused the taxpayer to initiate the software development in the first instance.

The IRS has concluded in a number of private letter rulings that, if the taxpayer bears the functional risk with respect to the software, the software is treated as developed rather than acquired by the taxpayer. We believe this is the correct policy. In determining whether the taxpayer bears the functional risk with respect to the software, contractual pricing provisions are important, but they should not be determinative.

Taxpayers often use fixed price purchase orders to control costs as each phase of a project goes forward and not to shift to the third party the risk that the goals of the project will be

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38 See § 5.01, Rev. Proc. 2000-50. Section 174 generally permits a taxpayer to deduct reasonable research or experimental expenditures, even though they might arguably be capital in nature.

39 In many instances, the contractual relationships for software development are based on a written agreement in which the parties identify the objectives to be sought and the specific work to be performed. Thereafter, purchase orders are issued periodically by the taxpayer that set out specifications for deliverables and the prices that have been agreed upon for those deliverables. Frequently, a purchase order will contain a fixed price for the enumerated deliverables, or alternatively a software development project may involve the issuance of multiple purchase orders each bearing a fixed price. In many situations, the taxpayer has the right to terminate the work if it concludes that the software will not produce the results for which the software is being developed even if the software operates as it was designed to operate.

achieved.41 Where the taxpayer otherwise bears the functional risk with respect to the software, however, the use of fixed cost purchase orders should not determine whether the software is treated as developed or purchased. To the contrary, where software is developed for use by the taxpayer and not for resale, and the taxpayer in fact bears the functional risk with respect to the software, the software should be treated as developed rather than acquired, even though the taxpayer has insisted that each phase of the work be undertaken only after agreement on the cost of that phase. Such a conclusion is consistent with the principles set forth in both sections 174 and 981. See Treas. Reg. § 1.174-2(b)(3) (where economic utility appears to be the key factor in the risk assessment analysis in the case of payments to a third party for research or experimentation) and Treas. Reg. § 1.861-18(d) (where a key factor in distinguishing the provision of services from other software transactions is the allocation of risk between the parties).

In conclusion, we believe that the regulations should confirm that software development costs include payments made to a third party so long as the taxpayer bears the functional risk with regard to the software. In making the determination as to whether the taxpayer bears the functional risk with regard to software, all of the facts and circumstances of the arrangement between the taxpayer and a third party are relevant. If the taxpayer bears the functional risk with regard to software, payments to third parties to assist in development of the software should be treated as deductible software development costs even if the contract calls for fixed payments.

C. Regular And Recurring Costs Should Be Deductible.

We believe the regulation should provide for the deductibility of regular and recurring business operations costs that arguably give rise to intangible benefits.42 As the IRS has previously recognized in Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising costs) and Rev. Rul. 96-62, 1996-53 I.R.B. 6 (training costs), certain categories of business costs that appear to have significant long-term benefits are actually general periodic costs that should be deducted currently.43 The majority of the benefits derived from advertising and training expenditures are relatively short-term; the short-term nature of these benefits is demonstrated through the taxpayer’s need to advertise on a regular basis and to train its employees on an ongoing basis.

Most other types of regular and recurring business operations costs that could be argued

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41 Although the third party may bear the risk of its failure to perform properly the specific tasks assigned to it, the taxpayer frequently bears the risk that the final product will not function to enable the taxpayer to achieve the results that caused the taxpayer to initiate the software development in the first instance. It is this functional risk that should be controlling for purposes of determining whether the taxpayer is considered to develop the software.

42 This is not the same factual inquiry as that of regular and recurring Corporate Transactions. While a few large taxpayers may acquire other businesses on a regular basis, we do not believe this should affect the capitalization treatment of the related costs. On the other hand, most business expenses incurred on a regular and recurring basis by a particular taxpayer (and not otherwise addressed in the ANPRM) should not be capitalized under section 263(a) for the reasons discussed in the text.

43 In both cases, business advertising and business training must occur on an ongoing and continuous basis. In a competitive business environment, customers must be reminded of the availability and pricing of the taxpayer’s goods and services, and employees must be trained and retrained to refresh and renew their skills and to adapt to new technologies and methodologies.
to give rise to intangible benefits should also be recognized as currently deductible in the proposed regulation. These costs, like advertising and training, yield primarily current benefits. For example, in order to remain competitive, businesses are continuously engaged in the re-engineering of management and operations processes and methodologies. In order to reduce uncertainty and provide consistency of treatment among taxpayers, we believe the regulations should clarify that these costs are deductible in light of their recurring nature and the uncertain size and duration of any benefit.

To some extent, the structure of the regulations will determine whether regular and recurring costs need to be separately addressed. If the regulations explicitly limit capitalization relating to intangibles under section 263(a) to the items listed in the ANPRM, there may no need to do so as these costs fall outside of those categories. (Nonetheless, clarification in the preamble would provide useful guidance.) On the other hand, if the regulations provide for an undefined category of other potentially capitalized costs or if the regulations do not explicitly state that capitalization will not be required under the “clear reflection of income” standard of section 446, useful certainty would be gained by a provision permitting the deduction of regular and recurring costs, including the costs of re-engineering management and operational processes.

D. Other Costs of Creating, Acquiring or Enhancing Intangible Assets or Benefits that Require Capitalization

The ANPRM states that the IRS and Treasury are considering what general principles of capitalization should be used to identify the costs of acquiring, creating or enhancing intangible assets or benefits that should be capitalized under section 263(a) but that are not already described in the ANPRM. The IRS and Treasury anticipate that these general principles will apply in rare and unusual circumstances to require capitalization of costs that are similar to those already described in the ANPRM. Comments are requested on capitalization principles (for example, a separate and distinct asset test or a significant future benefit test) that can be used to

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44 One of the most current examples of these types of expenses is the Total Quality Management (TQM) program that many businesses have adopted. In TAM 9544001, the Service addressed Just-In-Time (JIT) methods, a subcategory of the TQM program, concluding that the related costs should be capitalized, based primarily on a stipulated statement that the program had long-term benefit. Even under current guidance, it is far from clear that the TAM is correct. Although the TAM noted that the costs of achieving increased operating efficiencies are not per se capital as is indicated by Rev. Rul. 94-77, 1994-2 C.B.19, and Rev. Rul. 95-32, 1995-1 C.B. 8, it bootstrapped the ultimate outcome by determining that this benefit was sufficient to require capitalization, based upon the existence of “long-term benefits” in the statement of facts submitted with the TAM request. Having determined that capitalization is appropriate, the TAM applied a “plan” doctrine to capitalize all of the otherwise deductible regular and recurring expenses like training costs and consulting fees associated with the conversion to the JIT methodology, relying on True, Jr. v. United States, 894 F.2d 1197 (10th Cir. 1990) (costs of moving a gas extraction plant required to be capitalized as part of a general plan of rehabilitation).

The increased operating efficiencies and decreased response time were only one of the benefits realized by the taxpayer; the reduction of operating costs was equally significant. Nonetheless, the TAM determined without explanation that the increased operating efficiencies were the more predominant benefit and thus required capitalization of all of the costs. Further, the plan of rehabilitation doctrine relied upon the True court to capitalize moving costs has not been applied in contexts where the majority of the expenses yielded non-capital results. This can be seen in Situation 2 of Rev. Rul. 2001-4, 2001-3 I.R.B. 295, where the Service does not require capitalization of repair costs incurred as part of a heavy maintenance visit for an aircraft, since the substantial capital improvements necessary to apply the plan of rehabilitation doctrine are not present.
identify other costs that should be capitalized under section 263(a) and the administrability of such principles. The IRS and Treasury also request comments on other categories of costs associated with intangible assets or benefits that should be capitalized under section 263(a) and the administrability of such principles.

We agree with the approach taken in the ANPRM of specifically describing those categories of costs associated with intangible assets or benefits that should be capitalized. The IRS and Treasury certainly have the authority to issue additional guidance in the future describing other categories of costs that are required to be capitalized.

We do not believe that there is a single, general capitalization standard that can or should be used to identify the costs of acquiring, creating, or enhancing intangible assets or benefits that should be capitalized. We believe that an attempt to create and apply such a standard would perpetuate the uncertainty and controversy that exists today. In particular, we believe that a "significant future benefit test" is not a standard that can be administered consistently. Almost every expenditure results in some future benefit. Thus, a general "significant future benefit" test should not be a standard set forth in the regulations. Any other generalized standard would invite overbroad application, as well as "testing" of the general standard by taxpayers – in both cases defeating the certainty and administrability gained by the rest of the proposed rules.

Nonetheless, if the IRS and Treasury decide to include a "separate and distinct asset" test in the regulations, the regulations should set forth a definition of "separate and distinct asset." Some taxpayers have suggested that the regulations define a separate and distinct asset as a distinct and recognizable property interest that commonly is acquired separately from a trade or business (or could be so acquired if restrictions on assignability were ignored). We believe that this is a reasonable starting place, but recommend that any such definition be subject to the authority of the IRS and Treasury to make exceptions when experience so dictates. If this approach is adopted, we also recommend that the regulations set forth numerous examples of what is and what is not a separate and distinct asset.

E. **We Support a De Minimis Rule.**

Another simplifying rule that would greatly enhance the administration of this area of the tax law would be the adoption in the regulations of an overriding de minimis rule for costs relating to intangible assets and benefits. A de minimis rule should propose a reasonable threshold below which all expenses, determined on an expense-by-expense basis, should be deducted. We understand that such conventions are already in use as a practical matter in a number of districts in the audit of larger taxpayers. The use of such conventions should be expanded and made available on a uniform basis to all taxpayers by the adoption of a de minimis rule.

The validity of de minimis rules has already been recognized in cases where the use of the rules clearly reflected income and was required for regulatory purposes. We believe that the IRS should continue to build upon this basis and make available a de minimis rule that is not

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45 See Cincinnati, New Orleans, & Texas Pacific Railroad Co. v. United States, 191 Ct. Cl. 572 (1970); Union Pacific Railroad Co. v. United States, 208 Ct. Cl. 524 (1975); cf., Alacare Home Health Services, Inc. v. Com’r, T.C. Memo. 2001-149.
dependent upon rules mandated by financial or regulatory accounting, which may vary in application from industry to industry, as well as from taxpayer to taxpayer.

We recognize that one viable approach would be a uniform rule with a specific dollar amount applicable to all taxpayers, regardless of their level of income. 46 A single-amount de minimis rule (such as $5,000) would balance the competing concerns of administrability and distortion of income while providing a rule that would truly ease the recordkeeping burdens of the greatest number of taxpayers. The simplest and most efficient administration of this rule would be achieved by applying the threshold on a cost-by-cost basis, as opposed to a more expansive approach, such as a transaction-by-transaction basis. Although interpretative issues will arise no matter what standard is adopted, it would be easier to delineate the parameters of a given cost than to determine the parameters of a transaction. Further, most automated accounting systems can more easily apply a threshold test to individual items rather than to a more subjective grouping of items relating to the same transaction.

An alternative approach would establish the de minimis threshold based on a percentage of gross income, a particular type of revenue, or the size of the transaction, or other criteria, even it contains a ceiling per expenditure (such as $5,000). While this approach would add complexity, it would enable the rule to be tailored to the varying situations of taxpayers. Further, while it may appear inequitable in that large taxpayers are given more latitude than small ones, this is consistent with the likelihood that agents are better employed in the pursuit of other issues with a larger taxpayer.

If a “sliding scale” de minimis rule is promulgated, we believe that the best balance between equity and administrability would be achieved by a two-level de minimis rule based on gross receipts. Taxpayers with average gross receipts under a specific threshold, such as $2,000,000, for the prior three years 47 (determined on a consolidated group basis) would use one threshold, such as $2,000. Those with average gross receipts over this amount would use a higher threshold, such as $5,000. For most taxpayers, the amount to be used would be clear and consistent from year to year.

We believe this de minimis rule should be elective, and consideration should be given to making the election available both automatically and retroactively. On the other hand, revocations of the election might be permitted only with the consent of the Commissioner.

It should be emphasized that this de minimis rule would only apply to the cost of creating or enhancing intangible rights or benefits, and even then it would not apply to amounts paid to acquire section 197 intangibles or to amounts paid to purchase, originate or otherwise acquire any security, option, indebtedness, or financial interest under 197(e)(1). Further, we believe an

46 Other than the previously cited cases, which approve a $500 amount based upon regulatory accounting, there is little authority upon which to base the choice of a particular number for the threshold. Therefore, we believe that administrability, simplicity, and avoiding significant distortion of income should be the guiding factors in choosing a threshold. A key factor is the amount of work required by the IRS field to find and sustain these timing adjustments. This effort drains scarce resources from pursuing more important adjustments.

47 The use of a three-year average dampens the impact of a single anomalous year. The use of gross receipts recognizes that the volume of a taxpayer’s business is more likely to be consistent year to year than its net taxable income. Further, the use of prior year data (rather than current year) permits the taxpayer to determine its applicable threshold as it accounts for the year. The cost of compliance is not lessened when the taxpayer is unable to determine its de minimis threshold until after the tax year has ended.
appropriate anti-abuse rule should be included to prohibit the disaggregation of costs with a view to coming under the threshold. 48

F. We Recommend a Default Amortization Period.

The ANPRM states that the IRS and Treasury expect to provide safe harbor recovery periods and methods for certain capitalized expenditures that do not have readily ascertainable useful lives. The ANPRM requests comments regarding whether guidance should provide one uniform period or multiple recovery periods and methods. As noted above, we do not believe that the default life for individual intangible assets must be the same as the default life for recovery of Corporate Transaction Costs.

Certainly, capital expenditures relating to a security, option, any other financial interest described in section 197(e)(1), or any evidence of indebtedness should be recovered as part of the basis of that asset. Similarly, other intangible assets with readily ascertainable useful lives should be amortized over that life. Thus, an intangible asset with a legally defined life should be amortized over that life. For example, contract rights or licenses for a fixed number of years should be amortized ratably over that period. (As noted above, where financial instruments such as debt or preferred stock are involved, an alternative based on principal outstanding might be considered.) This most reasonably matches income and expense.

Considerations regarding an appropriate recovery period in the case of costs related to acquiring a trade or business and the like are discussed above.

In all other cases where no life is provided by the rules above, we recommend a default recovery period, such as 5 years. 49 Given the amorphous nature of many intangible assets, this would appear to achieve an equitable compromise between a purely theoretical approach to capitalization and one that fosters tax compliance and administrative efficiency. By making the default period available in all situations not described above, the regulations would discourage controversy regarding whether a life is “readily” ascertainable. Such a period is long enough to avoid most significant distortions of income, while short enough to encourage initial compliance and speedy resolution of disputes. Further, a default period provides certainty to taxpayers in both planning and compliance.

In order to eliminate any issues regarding the Treasury’s authority to impose a default recovery period where a taxpayer could argue that it has a shorter economic life, we recommend that this be provided as an elective safe harbor to taxpayers. 50 Since less sophisticated taxpayers may fail to avail themselves of the safe harbor, consideration should be given to permitting both automatic and retroactive elections, but not retroactive revocations of the

48 For example, the regulations might make clear that a taxpayer may not allocate some portion of the acquisition cost of tangible property to a new, innovative intangible asset embedded in the tangible property. It may also be reasonable to require that a taxpayer be able to describe on audit its processes for determining which costs fall below the threshold.

49 To reduce complexity, we do not propose a half-year convention, but do support ratable amortization.

50 For example, this could take the form of a regulatory provision or simultaneous Revenue Procedure that, like Rev. Rul. 2000-50 above, states that “the Service will not disturb a taxpayer's treatment of costs” consistent with this safe harbor, so long as it is applied to all costs within the scope of the election.
election without permission of the Commissioner.

In conjunction with the default amortization period, we believe the Treasury and IRS should consider whether a tax benefit or recapture rule should be applied to costs that were previously capitalized and amortized. More specifically, the proposed rulemaking might address instances in which gain from the disposition of an intangible asset or similar interest will be required to be characterized as ordinary income. A recapture rule might be required, for example, where a taxpayer recovers prior years’ amortization expenditures for an intangible asset having an indefinite useful life. This would prevent the conversion into capital gain of amounts previously deducted as ordinary income.\(^{51}\) Whether such a rule is promulgated should be based on a weighing of the increased complexity and administrative cost against the potential for manipulation of tax rates.

G. Coordination with Other Rules.

We believe the proposed regulations should clarify that (except as otherwise explicitly provided) the deductions and amortizations permitted are treated like other ordinary deductions. Thus, for example, all currently expensed items, as well as expenditures permitted to be amortized, will reduce corporate earnings and profits under section 312.\(^{52}\) For pass-through entities, the proposed regulations (or preamble) should clarify that items permitted to be expensed are subject to all other applicable limitations on deductions and result in application of the basis adjustment rules contained in sections 1367 (S corporations) and 705 (partnerships). It would also be helpful to make appropriate references to sections 651 and 661 (computing a trust’s distributable net income), to section 641(c)(2) (computing taxable income of an electing small business trust), and to the consolidated return regulations.\(^{53}\)

H. Effective Dates.

The effective date of any change in guidance is always a significant issue. When method changes are involved, the situation is further complicated by the requirement of Commissioner’s consent and an adjustment under section 481(a), if any. Normally, newly permissible methods of accounting are made effective prospectively using an appropriate section 481(a) adjustment or a cut-off method. When a primary goal of guidance is the efficient resolution of ongoing disputes, it is appropriate to permit retroactive application of the guidance.

Therefore, we recommend a combination of prospective and retroactive application. Taxpayers should be permitted to use automatic procedures to change their methods of accounting prospectively for the various items affected by the forthcoming regulations. To best

\(^{51}\) Cf., e.g., I.R.C. §§ 111, 1245(a)(3), 1245(a)(4), 197(f)(7), 1254, 263(c), 59(e), 57(a)(2), 617(b)-(d).

\(^{52}\) Section 312(n) provides special treatment for certain deductible items that would otherwise be capitalized, such as intangible drilling costs (section 312(n)(2)), circulation expenditures and corporate organizational expenditures (section 312(n)(3)). These variances from taxable income are designed to more clearly reflect economic income in the case of statutory exceptions to section 263. Since the deductions and amortizations to be provided in the forthcoming regulations are consistent with section 263, no further adjustment to earning and profits is warranted.

\(^{53}\) See, e.g., Treas. Reg. §1.1502-13(c)(7)(ii), Ex. (7).
accommodate all possible circumstances, cut-off changes should be eligible on an item-by-item basis. In fact, we encourage the IRS and Treasury to consider requiring that all automatic changes be made on a cut-off basis. The goals of administrability and burden reduction are not served by requiring taxpayers to dig into past years to compute section 481(a) adjustments. Further, cut-off changes prevent misuse of the new rules to “mine” the past for favorable section 481(a) adjustments, which is inconsistent with rules designed to reduce administrative burden.

We believe taxpayers should be permitted to make prospective changes (with audit protection as provided in current guidance) to broad categories of costs (such as “all internal costs related to creating or acquiring indefinite-term customer contracts”), so long as the items that would have to be capitalized are reasonably ascertainable. It should not be as important that items to be deducted are absolutely clear, if the alternative to falling within a class deductible under the new method is also deduction under the general rules of section 162.54

We also recommend that in the regulations (or by other guidance), the IRS and Treasury instruct Examination, Appeals, and Counsel to use the new regulations to the greatest extent possible as a template for resolution of current issues.55 This serves the purpose of administrability and may foster effective use of IRS resources. The methods of accounting permitted by the regulations should be considered permissible methods by the field when considering a taxpayer’s past method of accounting. Any method that substantially comports with a method in the regulations should be considered permissible, and any method that is no more favorable than a method in the regulations should be permissible for prior periods.56

Further, the new methods of accounting in the regulations should be permissible methods onto which the field may place the taxpayer. See Rev. Proc. 2002-18 (setting forth procedures for IRS-imposed method changes). On the other hand, taxpayers should not be permitted to unilaterally make a retroactive change to the new methods.

IV. Conclusion

We believe the IRS and Treasury are on the right track with approaches considered in the ANPRM, and we look forward to the proposed regulations. The ANPRM process has provided a useful opportunity for widespread taxpayer input before the actual drafting of proposed regulations is begun. We thank you for the opportunity to submit our comments, and we would welcome any further or more specific inquiries you may have.

54 In the example in the text, it is hardly useful to make a taxpayer define which types of cost relate to creating indefinite-term customer contracts since a type of cost that does relate to these contracts would become deductible and costs not related to these contracts would be deductible unless capitalized for another reason unrelated to the method change.

55 Similarly, it is hoped that taxpayers before Federal District Courts and Courts of Appeals would be given the opportunity by the Department of Justice to resolve issues based on these principles.

56 This protects the IRS from a taxpayer argument that the old method is impermissible, but a more generous method under the new regulations is now the only permissible method onto which the Service can place the taxpayer. We believe that retroactive application of the new rules by the IRS field should reduce controversies, but not be used by taxpayers to garner benefits not previously claimed.