April 15, 2005

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments Concerning the Treatment of Amounts Required to be Capitalized in Certain Transactions to which Treas. Reg. §1.263(a)-5 Applies (Notice 2004-18)

Dear Commissioner Everson:

Enclosed are comments on the treatment of amounts required to be capitalized in certain transactions to which Treas. Reg. §1.263(a)-5 applies. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, IRS
Nicholas J. DeNovio, Deputy Chief Counsel (Technical) IRS
Robert M. Brown, Associate Chief Counsel (Income Tax and Accounting) IRS
Andrew Keyso, Jr. Special Counsel to the Associate Chief Counsel (Income Tax and Accounting) IRS
Comments Concerning the Treatment of Amounts Required to be Capitalized in Certain Transactions to which Treas. Reg. §1.263(a)-5 Applies Notice 2004-18

The following comments were prepared by individual members of the Corporate Tax Committee of the Section of Taxation of the American Bar Association. These comments are 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 of the Section of Taxation.

Principal responsibility was exercised by Jamie Dahlberg and Jennifer Britt Giannattasio. Substantive contributions were made by Jack Cummings, R. David Wheat, Dan Brody, and Benjamin Wells. The Comments were reviewed by Robert H. Wollen of the Section’s Committee on Government Submissions and by Mark L. Yecies, Council Director for the Corporate Tax Committee.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments, or they have advised clients on the application of these principles, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

Contact Person: James L. Dahlberg
(202) 879-5393
dahlberg@deloitte.com

Jennifer Britt Giannattasio
(202) 879-4976
jegiannattasio@deloitte.com

Date: April 15, 2005
Comments Concerning the Treatment of Amounts Required to be Capitalized in Certain Transactions to which Treas. Reg. §1.263(a)-5 Applies
Notice 2004-18

Introduction

On December 22, 2003, the Treasury Department and Internal Revenue Service (the “Government”) issued final regulations (T.D. 9107; 69 FR 436) under section 263(a) of the Internal Revenue Code of 1986, as amended, sometimes referred to as the “INDOPCO” regulations. These regulations, in particular Treas. Reg. §1.263(a)-5, require that certain transaction costs be capitalized (herein “capitalized costs”) in the case of a taxable or nontaxable acquisition of a trade or business, an acquisition of a controlling interest in a business entity, a change in the capital structure of a business entity and certain other transactions. In several important instances, however, the regulations do not address the treatment of such amounts (i.e., when, if ever, such amounts may be eligible for recovery) in taxable stock acquisitions and nontaxable transactions. Rather, the preamble to the regulations states that the Government will issue separate guidance to address the treatment of such capitalized costs and will consider whether amortizing such amounts over a 15-year period is appropriate.

On March 18, 2004, in Notice 2004-18, the Government requested comments focusing on three issues that relate to the treatment of amounts that are required to be capitalized under the INDOPCO regulations. Specifically, comments were requested on (i) the treatment of capitalized costs (e.g., whether capitalized costs should increase the basis of a particular asset or assets, create a new asset that is or is not amortizable, reduce an amount realized or be an adjustment to equity); (ii) whether capitalized costs in a tax-free transaction should be treated in the same manner as capitalized costs in a taxable transaction; and (iii) whether capitalized costs should be treated in the same manner regardless of whether the party incurring such costs is an acquirer or a target. Notice 2004-18 goes on to state that the Government intends to issue proposed regulations with a set of rules that are clear and administrable, thereby reducing future controversy regarding eleven specified types of transactions. In addition to these eleven types of transactions, we believe consideration should be given as to whether similar guidance

1 Hereinafter all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.
2 11 I.R.B. 605.
3 The eleven types of transactions described in Notice 2004-18 are (1) tax-free asset acquisitions and dispositions such as reorganizations under section 368(a)(1)(A), (C), (D), and (G); (2) taxable asset acquisitions and dispositions; (3) tax-free stock acquisitions and dispositions such as reorganizations under section 368(a)(1)(B); (4) taxable stock acquisitions and dispositions; (5) tax-free distributions such as distributions to which sections 305 or 355 apply; (6) tax-free distributions of property such as distributions to which sections 332 and 337 apply; (7) taxable distributions of property such as distributions to which sections 331 and 336 apply; (8) organizations of corporations, partnerships and disregarded entities such as transfers described in sections 351 or 721; (9) corporate recapitalizations; (10) reincorporations of corporations in a different state (for example, in a reorganization under section 368(a)(1)(F)); and (11) issuances of stock.
regarding recovery of capitalized costs should be extended to transactions involving partnerships.

We respectfully submit the following comments on the three issues regarding capitalized transaction costs: (i) treatment of such capitalized costs generally; (ii) treatment of such capitalized costs in a taxable versus tax-free transaction, and (iii) treatment of such capitalized costs incurred by an acquirer versus a target.

Executive Summary

Proposed Treatment of Capitalized Costs

I. Treatment of Capitalized Costs Generally

We believe that, conceptually, a correct matching of income and expense generally results if capitalized costs incurred by the acquirer in an acquisition are added to the basis of assets acquired. We are concerned, however, that, under such rules, controversy could arise as to the method for allocating such costs among acquired assets, and also as to the recovery of capitalized costs in non-acquisitive transactions. Also, this general principle would not address the proper treatment of costs incurred by a selling corporation or a target entity. Thus, in the interest of promoting consistent and efficient administration, we believe capitalized costs should give rise to a separate intangible asset with an amortizable useful life of 15 years. The authority to adopt such a rule is discussed in section IV below.

II. Taxable versus Tax-Free Transaction

The INDOPCO regulations treat capitalized costs incurred by a selling corporation in a taxable asset acquisition as a reduction of the amount realized and capitalized costs incurred by the acquirer as amounts added to the basis of the acquired assets or stock acquired. The INDOPCO regulations reserve on the treatment of capitalized transaction costs incurred by a target in a taxable stock acquisition in which no section 338 election is made, and similarly reserve on the treatment of capitalized transaction costs incurred by a target or acquirer in a tax-free stock or asset transaction.

We believe that there are strong policy considerations for a uniform rule. We note, however, that special considerations may apply to the costs of a selling corporation in a taxable asset sale, the costs incurred by a target shareholder upon a disposition of...
stock, and the costs incurred by an acquirer upon an acquisition of target stock. Therefore, the following comments do not apply to these categories of costs.

Except as just noted, we recommend that regardless of the type of transaction, acquisitive or non-acquisitive, and regardless of who incurs transaction costs, as a policy matter, and in the interest of efficient administration, capitalized transaction costs should give rise to an intangible asset with an amortizable useful life of 15 years. In other words (except as noted), this 15-year rule should apply to all eleven transactions listed in Notice 2004-18. A later transaction occurring prior to the expiration of the 15-year amortization period would accelerate the recovery period if the transaction results in a taxable disposition of the entire business.\textsuperscript{7}

III. **Acquirer versus Target**

Except as noted, the parties to an acquisition, or to any of the other transactions listed in Notice 2004-18, all should treat capitalized costs in the same manner. Thus, in the case of an acquisitive transaction (i.e., a taxable stock or asset acquisition, or any tax-free acquisition), except as noted, all parties should treat capitalized costs as giving rise to an intangible asset with an amortizable useful life of 15 years.

Similarly, in the case of a non-acquisitive transaction, each party to the transaction incurring costs should treat capitalized costs as giving rise to an intangible asset with an amortizable useful life of 15 years. For example, in the case of a divisive reorganization or other section 355 distribution, capitalized costs of the distributing corporation and the controlled corporation each would be recoverable over a 15-year period. In the case of section 351 and section 721 transactions, capitalized costs of the transferor and transferee would be recoverable over a 15-year period. In the case of a recapitalization, a reincorporation, a section 305 distribution or a stock issuance, costs incurred by the corporation recapitalizing, reincorporating, distributing its own stock or issuing stock would be recoverable over 15-years.\textsuperscript{8}

IV. **Authority to Amortize over 15 Years**

We believe that it is appropriate for the Government to provide a rule that treats capitalized transaction costs as an intangible asset with a useful life of 15 years. Support for such a rule can be found in the authority granted under section 446 and the strong policy statement made by the United States Supreme Court in *INDOPCO, Inc. v.*

\textsuperscript{7} Acceleration of the recovery period in the case where there is a disposition of the entire business would be consistent with the Government’s recently issued technical advice memorandum 2005-02-039 (January 14, 2005). Some taxpayers have taken a position contrary to the technical advice and deducted a target’s capitalized costs when there has been a liquidation and dissolution of the target without regard to whether the business is sold.

\textsuperscript{8} For the sake of simplicity, the remaining comments are written in the context of an acquisition, but should be interpreted to apply equally to the non-acquisitive transactions listed in Notice 2004-18.
As previously stated, except as otherwise noted, these rules should apply to all of the capitalized costs identified in Notice 2004-18, including reorganization and stock issuance costs.

**Analysis**

I. **Treatment of Capitalized Costs Generally**

In concluding that capitalized costs should be treated as giving rise to an intangible asset with an amortizable useful life of 15 years, it is helpful to understand current case law, the INDOPCO regulations, and how adopting such a rule eliminates any potential recovery differences resulting from different allocation methodologies, different types of transactions, and different parties incurring the costs.

a. **Current Case Law and the INDOPCO Regulations**

i. **Acquirer Costs in an Acquisitive Tax-Free Transaction**

The question of how capitalized costs should be treated by an acquiring corporation has been addressed in the context of a tax-free reorganization by the Second Circuit Court of Appeals in *McCrory Corporation v. United States*. In *McCrory*, the court was faced with the question of whether capitalized expenditures incurred in connection with the acquisition of ongoing lines of business by tax-free reorganization should be treated as, (i) reorganization costs that are an intangible asset of the acquiring corporation, or (ii) incident to the purchase of assets. The court concluded that the costs should be capitalized as part of the cost of the assets and either amortized or depreciated over the life of the assets, or, in the case of nonamortizable or nondepreciable assets, deducted when the assets are sold or abandoned.

---


10 It may be appropriate to continue to provide, as in Treas. Reg. §1.263(a)-5(g)(2)(i), that the acquirer’s costs in a taxable asset acquisition should be added to the basis of the assets acquired. To be consistent, however, we believe that the 15-year amortization rule should apply in this context as well. In most cases, there should be no difference in result, as capitalized transaction costs are typically allocated to Class VI or VII.

11 We previously submitted comments of individual members of this committee stating that stock issuance costs give rise to an intangible asset that should be recovered at some point in time. See the ABA’s Comments on Proposed Regulations Regarding Deduction and Capitalization of Intangible Asset Expenditures REG125638-01, 2003 TNT 99-20 (the “ABA Proposed Regulation Comment Letter”).

12 651 F.2d 828 (2nd Cir. 1981).

13 See Ginsburg and Levin, *Mergers, Acquisitions, and Buyouts*, ¶602.3.1 (Aspen Publishers, December 2004). By analogy, the acquirer’s capitalized costs in certain non-acquisitive transactions such as D/355 transactions and section 351 and 721 transactions could also be added to the basis of the assets acquired.
ii. Acquirer Costs in an Acquisitive Taxable Transaction

Treas. Reg. §1.263(a)-5(g)(2)(i) applies similar treatment to costs incurred by an acquirer in a taxable acquisition. In other words, an acquirer’s capitalized transaction costs in a taxable acquisition are to be added to the acquirer’s basis in the stock or assets acquired, and such costs are properly recovered as part of the recovery of the basis of the assets (in the case of a transaction treated as an asset acquisition) or upon the disposition of the stock (in the case of a transaction treated as a stock acquisition).

iii. Target Costs in an Acquisitive Tax-Free Transaction

In the case of a target’s capitalized transaction costs in a tax-free asset acquisition, some have taken the position that such costs are added to the target’s basis in its assets immediately prior to the acquisition.\(^{14}\) This treatment in effect passes on the benefit of such costs to the acquirer, because the latter will take a carryover basis in the assets under section 362(b).

A target’s capitalized transaction costs in a tax-free stock acquisition result in a separate intangible asset with an indefinite useful life, recoverable at the point in time when there is no continuing future benefit associated with that intangible asset.\(^{15}\)

iv. Target Costs in an Acquisitive Taxable Transaction

Similar to a tax-free acquisition discussed above, in a taxable stock acquisition, a target’s capitalized transaction costs are viewed as a separate intangible asset with an indefinite useful life, recoverable at the point in time when there is no continuing future benefit associated with that intangible asset.

v. Selling Corporation’s Costs in an Acquisitive Taxable Transaction

Treas. Reg. §1.263(a)-5(g)(2)(ii)(A) provides that the seller’s capitalized transaction costs in a taxable asset acquisition must be treated as a reduction of the seller’s amount realized on the disposition of its assets, rather than as an allocation of such costs to the assets of seller.\(^{16}\)

---

\(^{14}\) Cf Kirschenmann v. Comm’r, 488 F.2d 270 (9th Cir. 1973).  


\(^{16}\) As discussed above, in taxable and tax-free asset acquisitions some taxpayers have treated a seller’s costs as an increase to the basis of assets transferred. The regulations reserve on the treatment of a target’s capitalized transaction costs in a taxable stock acquisition.
b. Adopting a 15-year Rule

Adopting a rule that allows for the amortization of all capitalized transaction costs over a 15-year period would eliminate any potential difference in recovery resulting from (i) different allocation methodologies, and (ii) the type of transaction and (iii) the party incurring the costs.

i. Allocation Using Different Methodologies

Potential differences in the timing of recovering capitalized costs can arise in acquisitive transactions if capitalized costs are allocated to assets using different methodologies. For example, capitalized transaction costs could be allocated based on relative fair market value obtained via appraisal, or based on relative book value where an appraisal has not been obtained. (The residual method of sections 1060 and 338 would not apply in a tax-free reorganization.) Furthermore, there are various appraisal methodologies, which could result in different cost recovery periods among different taxpayers. Under a rule requiring a selling corporation, a target and an acquirer to capitalize transaction costs into an intangible asset amortizable over 15 years, the difficulty in selecting the methodology for actually allocating capitalized transaction costs would not exist.

ii. Difference in the Treatment of Capitalized Costs among the Eleven Listed Types of Transactions

a. Current Treatment

As discussed above, in a taxable or tax-free acquisition of assets or stock, an acquirer adds its capitalized transaction costs to the basis of the target assets or stock acquired. In the case of an asset acquisition, such costs are amortizable over the life of the assets, and in the case of a stock acquisition, such costs are recovered if the stock is ever sold. In the case of a stock acquisition, if the target is liquidated in a section 332 liquidation such costs are never recovered. In a taxable acquisition of assets, the INDOPCO regulations provide that seller reduces the amount realized. In a tax-free asset acquisition, some have taken the position that the selling corporation’s capitalized costs are added to the basis of the assets transferred, and thereby carry over to the acquirer. In a taxable or tax-free acquisition of stock, the target’s costs are capitalized and recovered when there is no continuing future benefit associated with such costs.

As previously stated, taxpayers have taken the position that the acquirer’s capitalized costs in the listed non-acquisitive transactions, such as a divisive reorganization, a section 351 transaction or a section 721 transaction, are treated the same as those incurred in an acquisitive transaction and added to the basis of the assets acquired. Some may have also taken the position that the transferor’s capitalized costs are similarly added to basis and carry over to the acquirer. In the case of a recapitalization, reincorporation, section 355 distribution, or a section 305 distribution, capitalized costs are recovered when there is no continuing future benefit. With regard to
stock issuance costs, taxpayers have capitalized such costs and claimed a deduction for such costs when the stock is no longer outstanding.\textsuperscript{17}

\textbf{b. Suggested Treatment}

There are clearly timing differences, and in some instances permanent differences, in the recovery of capitalized costs, depending upon whether such costs were incurred by acquirer, selling corporation or target, whether the transaction was a stock or asset acquisition, whether the transaction was taxable or tax-free, or whether the transaction was an acquisitive or non-acquisitive transaction. Providing a rule allowing for recovery of capitalized transaction costs over 15 years in the eleven types of transactions listed in Notice 2004-18 (except as noted) would eliminate these differences in the recovery of such costs and, in certain cases, would enable a taxpayer to recover transaction costs that would otherwise never be recovered, or recovered at some uncertain date, thus achieving a better matching of income and expenses.

\section{II. Taxable versus Tax-Free Transaction}

There is no readily apparent justification for treating capitalized transaction costs differently depending upon whether the costs are incurred in a taxable versus tax-free transaction. [In what case is the treatment under current law different?] In addition, as discussed above, such differing treatment can result in artificial timing differences in the recovery of such costs. By adopting a rule providing for treating capitalized transaction costs as an intangible asset that is amortizable over 15 years, there would be no distinction in the treatment of costs in a taxable versus tax-free transaction.

\section{III. Acquirer versus Seller/Target}

As is the case with taxable versus tax-free transactions, there is no apparent justification for treating an acquirer’s capitalized transaction costs differently from those incurred by a selling corporation or the target. Again, treating capitalized transaction costs as an intangible asset with a useful life of 15 years would eliminate any potential distinctions. Especially in the context of a tax-free reorganization, the acquirer and target have similar goals: synergies, etc. resulting from the business combination. Accordingly, it makes sense to treat the transaction costs in a parallel fashion.

\section{IV. Appropriateness of 15-year Recovery}

Notice 2004-18 points out that a useful life of 15 years may be appropriate and would be consistent with Treas. Reg. §1.167(a)-3(b). Such a rule would also be consistent with section 902 of the American Jobs Creation Act of 2004, which provides for 15 year recovery under sections 195, 248 and 709. We believe that a useful life of 15 years reflects economic reality and is an appropriate timeframe in which to recover capitalized transaction costs.

\textsuperscript{17} In technical advice memorandum 2005-03-026 (October 26, 2004), the Government concluded that stock issuance costs are netted against the proceeds of a stock issuance.
Whether capitalized transaction costs are incurred in a taxable or tax-free transaction, by a selling corporation, a target or an acquirer, real dollars have been spent with the expectation that they will generate a return over some reasonable period of time. Any period beyond 15 years stretches the reasonable expectation of generating a return because capitalized transaction costs generally do not match up against any income or benefit that is earned more than 15 years after the costs are incurred. The net present value of costs recovered in the distant future can be so small as to be negligible.

V. Authority to Amortize over 15 Years

We believe the Government has authority to issue a regulation that treats capitalized transaction costs as an intangible asset with a useful life of 15 years. Section 446(b) grants the Government authority to provide for a method of accounting that results in the clear reflection of income in those cases where the taxpayer has not regularly used a method of income or the method so used does not clearly reflect income. In addition, the Government has authority under section 446 to adopt regulations that establish tax accounting methods that “clearly reflect income.” The Government has recently used this authority to promulgate regulations that require the amortization of debt issuance costs over the lifetime of the debt to which such costs are attributable. The Government similarly has authority to promulgate regulations, pursuant to the same policy goal, that would govern the recovery of other capitalized facilitative costs, i.e., those described in Treas. Reg. §1.263(a)-5.

The case law also supports adoption of a rule that will result in the matching of expenditures with revenues of a taxable period to which such expenditures are attributable. In INDOPCO, the United States Supreme Court stated:

> While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. . . . Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.

Similarly, the Tax Court recently stated this view in Lychuck v. C.I.R.:

---

18 In the ABA Proposed Regulation Comment Letter, we stated that a 15 year amortization period for reorganization costs in either an acquisitive or non-acquisitive tax-free acquisition is inconsistent with section 197(e)(7) (formerly section 197(e)(8) prior to the American Jobs Creation Act of 2004) and its legislative history. While we still hold such belief, as will be discussed, section 197(e)(7) itself does not prohibit the Government from treating capitalized costs as an intangible asset under another provision of the Code.
19 Treas. Reg. §1.446-5.
20 Absent section 446, the Service also has general authority to issue regulations that are necessary for the enforcement of Title 26.
21 503 U.S. at 83-84.
The Supreme Court stated explicitly in *INDOPCO, Inc. v. C.I.R.* . . . that our Federal income tax system endeavors to match expenses with the related revenue in the taxable period for which the income is recognized. The Court stated in *Commissioner v. Idaho Power Co.*, [418 U.S.] at 16, that “[t]he purpose of section 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing.”

While we believe that the Government has the authority to promulgate a regulation that treats capitalized transaction costs as an intangible asset with a useful life of 15 years, the question may arise as to whether such a regulation would be inconsistent with section 197(e)(7). Section 197(e)(7) provides that fees for professional services and transaction costs incurred by parties to a transaction in which any portion of the gain or loss is not recognized under part III of subchapter C of the Code are not section 197 intangibles.

Section 197(e)(7) was enacted after *INDOPCO* was decided. As discussed above, *INDOPCO* stands for the proposition that transaction costs incurred in connection with a reorganization must be capitalized, even where they cannot be associated with a specific, identifiable asset. Costs that cannot be associated with a specific identifiable asset ordinarily can only be recovered upon the dissolution of the enterprise. Congress apparently was concerned that taxpayers would argue that such costs were section 197 intangibles. The legislative history of section 197(e)(7) provides some insight into Congress’s concern in enacting section 197(e)(7). The House-Senate Conference Committee specifically states:

> This provision addresses a concern that some taxpayers might attempt to contend that the [15]-year amortization provided by the provision applies to any such amounts that may be required to be capitalized under present law but that do not relate to any asset with a readily identifiable useful life. The exception is provided solely to clarify that section 197 is not to be construed to provide [15]-year amortization for any such amounts.

In the ABA Proposed Regulation Comment Letter, it was suggested as a general proposition that recovery over 15 years would be inconsistent with section 197(e)(7) and its legislative history. Our recommendation was to apply specific rules to specific transactions. On reflection, we have changed our views. Even though section 197(e)(7) presents an issue, consistent with the *INDOPCO* regulations, which adopt bright line rules and rules of simplification, on balance we think that 15-year amortization is the least complicated and therefore the most desirable rule.

---

22 116 T.C. at 410.

23 Recoverable basis in some other section 197 intangible asset, e.g., goodwill or a trademark, could include transaction costs incurred in a taxable transaction (i.e., a transaction in which there is no non-recognition of gain or loss under part III of subchapter C.) Similarly, as discussed above, *McCrary* held that an acquirer’s capitalized transaction costs in a tax-free acquisition of a target are added to the acquirer’s basis in the target’s assets acquired.

Again, we commend the Service for considering rules that are intended to provide guidance and simplicity. Adopting a rule that would treat capitalized transaction costs as an intangible asset with a useful life of 15 years would achieve the policy goal articulated by the United States Supreme Court by better matching expenditures to the time periods in which such expenditures generate income, and would be consistent with section 902 of the American Jobs Creation Act of 2004. We would be happy to work with you to achieve this result.