

Department
of the
Treasury

Internal
Revenue
Service

Office of
Chief Counsel

Notice

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Subject : Change in Litigating Position _____ Cancellation Date: Upon Incorporation _____ into the CCDM _____

The purpose of this Notice is to announce a change in the Service's litigating position regarding capitalization under section 263(a) of transaction costs related to the acquisition, creation, or enhancement of intangible assets or benefits. As discussed below, the Service will not assert that certain employee compensation, fixed overhead, or de minimis transaction costs must be capitalized under section 263(a).

Section 263(a) requires taxpayers to capitalize expenditures to acquire, create, or enhance separate and distinct assets or certain significant future benefits. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971). The Supreme Court has long held that capitalization is required not only for the cost of the asset itself, but for ancillary transaction costs incurred in the process of acquisition. Woodward v. Commissioner, 397 U.S. 572 (1970); Helvering v. Winmill, 305 U.S. 79 (1938).

Substantial controversy and uncertainty has developed regarding whether particular transaction costs are sufficiently related to the acquisition, creation, or enhancement of an intangible asset or benefit as to require capitalization of such costs under section 263(a). Recent court decisions are difficult to reconcile, particularly where the transaction costs in question are fixed costs such as employee salaries and overhead. Compare PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822 (3rd Cir. 2000), rev'g 110 T.C. 349 (1998) (permitting a

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deduction for salaries and other transaction costs incurred by a bank in originating loans to borrowers because, while such costs may have been “directly related to the creation of the loans,” such costs did not themselves “create” the loans) with Lychuk v. Commissioner, 116 T.C. 374 (2001) (requiring capitalization of employee salaries because such salaries originated in the loan acquisition process and therefore were directly related to the acquisition; permitting a deduction for overhead costs because such costs did not originate in the loan acquisition process and therefore were only indirectly related to the acquisition). See also Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000) (permitting a deduction for salaries of corporate officers who spent part of their time negotiating a merger transaction because the salaries originated from, and were directly related to, the employment relationship between the taxpayer and the officers, and were only indirectly related to the merger transaction).

The Service and Treasury expect to publish a notice of proposed rulemaking (NPRM) during 2002 clarifying the application of section 263(a) to expenditures (including transaction costs) incurred in acquiring, creating, or enhancing intangible assets or benefits. On January 24, 2002, the Service and Treasury published an advance notice of proposed rulemaking (ANPRM) describing and explaining rules and standards expected to be proposed and requesting public comment on these rules and standards.

As discussed in section C of the ANPRM, the Service and Treasury expect to propose a rule that requires capitalization of transaction costs that facilitate an acquisition, creation, or enhancement of certain intangible assets. This rule is also expected to require capitalization of transaction costs that facilitate an 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. The Service and Treasury anticipate that this rule will not require capitalization of employee compensation (except for bonuses and commissions that are paid with respect to the transaction), fixed overhead, or de minimis costs (i.e., costs that do not exceed a specified dollar amount).

The Service has concluded that it is an inefficient use of resources to litigate certain transaction cost issues while in the process of proposing regulations that may ultimately allow a current deduction for such costs. Accordingly, until further guidance is finalized, the Service will not assert capitalization under section 263(a) for employee compensation (other than bonuses and commissions that are paid with respect to the transaction), fixed overhead, or de minimis costs related to the acquisition, creation, or enhancement of intangible assets or benefits. For purposes of this Notice, costs will be considered de minimis to the extent they do not exceed \$5,000 per transaction.

