HIGHLIGHTS
OF THIS ISSUE
These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Actual and constructive sales. This ruling holds that a shareholder has neither sold stock currently under section 1001 of the Code nor caused a constructive sale of stock under section 1259 if the shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not otherwise economically compelled to deliver the pledged shares.

Final regulations under section 446 of the Code confirm that the timing rules of the intercompany transaction regulations of section 1.1502–13 are a method of accounting.

REG–125638–01, page 373.
Proposed regulations explain how section 263(a) of the Code applies to amounts paid to acquire, create, or enhance intangible assets. The regulations also provide safe harbor amortization under section 167(a) for certain intangible assets and explain the manner in which taxpayers may deduct debt issuance costs. A public hearing is scheduled for April 22, 2003.

EMPLOYEE PLANS

Notice 2003–9, page 369.
Equity investments prior to allocation. The Treasury Department and the Service announce that they will amend section 1.45D–1T(c)(3)(iii) of the temporary regulations to extend a deadline relating to certain equity investments made before the receipt of a new markets tax credit allocation under section 45D(f)(2) of the Code.

EMPLOYEE PLANS

Definition of early retirement benefits and retirement-type subsidies. The IRS and the Treasury intend to propose regulations and are requesting comments regarding benefits that are treated as early retirement benefits or retirement-type subsidies for purposes of section 411(d)(6)(B) of the Code, including guidance on the extent to which payments that are contingent on the occurrence of an unpredictable event are protected under section 411(d)(6)(B). Notice 2002–46 modified.

EXCISE TAX

Final regulations under section 4374 of the Code relate to liability for the insurance premium excise tax. The regulations affect persons who make, sign, issue, or sell a policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer.

(Continued on the next page)
Final regulations under section 7526 of the Code exclude certain low-income taxpayer clinics (LITCs) that qualify for grants from the definition of income tax return preparer under section 7701(a)(36). The regulations also exclude certain persons who are employed by, or volunteer for, such clinics.

This procedure provides guidance on the administrative appeal rights of a spouse or former spouse when a taxpayer seeks innocent spouse relief from federal income tax liability under section 6015 of the Code.


This advance notice of proposed regulations invites individuals and organizations to submit comments on revising the rules governing practice before the IRS (Circular No. 230) to address certain issues regarding standards of practice of attorneys, certified public accountants, enrolled agents, enrolled actuaries and appraisers who represent taxpayers before the Service.
The IRS Mission

Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury’s Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 446.—General Rule for Methods of Accounting


T.D. 9025

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

Intercompany Transactions: Conforming Amendments to Section 446

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: On July 18, 1995, the Treasury Department and the IRS published final regulations governing the intercompany transaction system of the consolidated return regulations. Those regulations state that the timing rules of the intercompany transaction system are a method of accounting. At the time of the publication of those regulations, no amendment was made to the regulations promulgated under section 446 to coordinate with that statement. This document contains final regulations confirming that the timing rules of the intercompany transaction regulations are a method of accounting. These regulations apply to all taxpayers filing consolidated returns.

DATES: Effective Date: These regulations are effective on December 16, 2002.

FOR FURTHER INFORMATION CONTACT: Vincent Daly, (202) 622–7770, or Jeffery G. Mitchell (202) 622–4930 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On July 18, 1995, the Treasury Department and the IRS published in the Federal Register (T.D. 8597, 1995–2 C.B. 147 (60 FR 36671)) final regulations under § 1.1502–13 governing the intercompany transaction system of the consolidated return regulations. Included in such regulations was an express statement that “[t]he timing rules of [the intercompany transaction regulations] are a method of accounting for intercompany transactions, to be applied by each member in addition to the member’s other methods of accounting.” § 1.1502–13(a)(3)(i). At the time of the publication of those final regulations, no amendment was made to the regulations promulgated under section 446 to coordinate with the statement in § 1.1502–13(a)(3)(i) that the timing rules of § 1.1502–13 are a method of accounting.

In General Motors v. Commissioner, 112 T.C. 270 (1999), the Tax Court determined that the timing rule of former § 1.1502–13(b)(2) was not a method of accounting for purposes of section 446(e). On November 7, 2001, the Treasury and the IRS published in the Federal Register a notice of proposed rulemaking (REG–125161–01, 2001–2 C.B. 538 [66 FR 56262]) proposing amendments to CFR part 1 under section 446 of the Internal Revenue Code to confirm that the timing rules of § 1.1502–13 are a method of accounting. No written comments responding to the notice of proposed rulemaking were received, and no public hearing was requested or held. Therefore, the proposed regulations are adopted by this Treasury decision without change.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Vincent Daly, Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.446–1 is amended by adding paragraph (c)(2)(iii) to read as follows:

§ 1.446–1 General rule for methods of accounting.

(c) * * *

(2) * * *(i) * * *

(iii) The timing rules of § 1.1502–13 are a method of accounting for intercompany transactions (as defined in § 1.1502–13(b)(1)(i)), to be applied by each member of a consolidated group in addition to the member’s other methods of accounting. See § 1.1502–13(a)(3)(i). This paragraph (c)(2)(iii) is applicable to consolidated return years beginning on or after November 7, 2001.

Par. 3. In § 1.1502–13, the second sentence of paragraph (a)(3)(i) is revised to read as follows:

§ 1.1502–13 Intercompany transactions.

(a) * * *

(3)* * * (i) * * * See § 1.1502–17 and, with regard to consolidated return years beginning on or after November 7, 2001, § 1.446–1(c)(2)(iii). * * *
Section 1001.—Determination of Amount of and Recognition of Gain or Loss

26 CFR 1.1001–1: Determination and recognition of gain or loss.

(Also § 1259.)

Actual and constructive sales. This ruling holds that a shareholder has neither sold stock currently under section 1001 of the Code nor caused a constructive sale of stock under section 1259 if the shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not otherwise economically compelled to deliver the pledged shares.

Rev. Rul. 2003–7

ISSUES

Has a shareholder either sold stock currently or caused a constructive sale of stock under § 1259 of the Internal Revenue Code if the shareholder (1) receives a fixed amount of cash, (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, (3) pledges the maximum number of shares for which delivery could be required under the agreement, (4) has the unrestricted legal right to deliver the pledged shares or to substitute cash or other shares for the pledged shares on the delivery date, and (5) is not economically compelled to deliver the pledged shares?

FACTS

An individual (“Shareholder”) held shares of common stock in Y corporation, which is publicly traded. Shareholder’s basis in the shares of Y corporation is less than $20 per share. On September 15, 2002 (the “Execution Date”), Shareholder entered into a margin’s agreement (“Y Agreement”) with Investment Bank, at which time a share of common stock in Y corporation had a fair market value of $20. Shareholder received $20 of cash upon execution of the Agreement. In return, Shareholder became obligated to deliver to Investment Bank on September 15, 2005 (the “Exchange Date”), a number of shares of common stock of Y corporation to be determined by a formula. Under the formula, if the market price of a share of Y corporation common stock is less than $20 on the Exchange Date, Investment Bank will receive 100 shares of common stock. If the market price of a share is at least $20 and no more than $25 on the Exchange Date, Investment Bank will receive a number of shares having a total market value equal to $2000. If the market price of a share exceeds $25 on the Exchange Date, Investment Bank will receive 80 shares of common stock. In addition, Shareholder has the right to deliver to Investment Bank on the Exchange Date cash equal to the value of the common stock that Shareholder would otherwise be required to deliver under the formula.

In order to secure Shareholder’s obligations under the Agreement, Shareholder pledged to Investment Bank on the Execution Date 100 shares (that is, the maximum number of shares that Shareholder could be required to deliver under the Agreement). Shareholder effected this pledge by transferring the shares in trust to a third-party trustee, unrelated to Investment Bank. Under the declaration of trust, Shareholder retained the right to vote the pledged shares and to receive dividends.

Under the Agreement, Shareholder had the unrestricted legal right to deliver the pledged shares, cash, or shares other than the pledged shares to satisfy its obligation under the Agreement. Shareholder is not otherwise economically compelled to deliver the pledged shares. At the time Shareholder and Investment Bank entered into the Agreement, however, Shareholder intended to deliver the pledged shares to Investment Bank on the Exchange Date in order to satisfy Shareholder’s obligations under the Agreement.

LAW AND ANALYSIS

Section 1001(c) provides that, except as otherwise provided in subtitle A of the Code, the entire amount of gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized. The Code does not define a “sale or exchange.” The courts have considered many factors significant in determining whether a sale or other disposition of property has occurred. The factors that are relevant, and the weight to be accorded to each factor, must be determined in light of the nature of the property involved. See Torres v. Commissioner, 88 T.C. 702, 721 (1987).

Several cases have addressed the transfer of securities to a brokerage firm under a subordination agreement intended to allow the brokerage firm to use the securities to meet its net capital requirements under stock exchange rules. See, e.g., Cruttenden v. U.S., 644 F.2d 1368 (9th Cir. 1981); Lorch v. Commissioner, 70 T.C. 674 (1978), aff’d, 605 F.2d 657 (2d Cir. 1979), cert. denied, 444 U.S. 1076 (1980); Miami National Bank v. Commissioner, 67 T.C. 793 (1977). In these cases, an owner of marketable securities transferred legal title and actual possession of the securities to the brokerage firm, which held the securities in a subordination account under an agreement that permitted the brokerage firm to sell the securities if necessary to meet claims of general creditors of the brokerage firm. The transferor, however, retained the right to receive dividends and the right to vote any stock. In addition, the transferor could reacquire the securities in the subordination account by substituting either cash or other securities of equivalent value.

In Miami National Bank, the court held that despite the right of the brokerage firm to sell stock in a subordination account to satisfy its creditors, the transferor remained the owner of the stock. As a result, the court held that the transferor’s subsequent sale of the stock in the subordination account was effective to permit the purchaser to be treated as the direct owner of the stock for purposes of the consolidated return own-
At all times, the transferor had the right to reacquire the stock in the subordination account by substituting cash or other readily marketable securities of equivalent value. The court gave significant weight to this right in holding that the creation of the subordination account did not cause the brokerage firm to become the owner of the stock in the subordination account. The court noted that the transferor’s right of substitution was not “merely an idle one” because, at all times, the transferor possessed sufficient resources to exercise the right. In fact, after the brokerage firm became insolvent, the transferor substituted cash for the stock. Thus, Miami National Bank and other similar cases indicate that a transfer of actual possession of stock or securities and legal title may not itself be sufficient to constitute a transfer of beneficial ownership when the transferor retains the unrestricted right and ability to reacquire the securities.

In cases addressing short sales of stock or securities, the courts have refused to recognize covering purchases as triggering a sale because, until actual delivery, the taxpayer retains the unrestricted right to dispose of the covering shares. See, e.g., Richardson v. Commissioner, 121 F.2d 1 (2d Cir.), cert. denied, 314 U.S. 684 (1941). In a typical short sale, the taxpayer borrows stock or securities to effect a short sale and is under an obligation to return identical stock or securities to the lender. In Richardson, the taxpayer entered into numerous sales, which were generally short sales effected with borrowed stock. In one case, the taxpayer purchased 7,100 shares of stock that were intended to be used to close out a short sale but were in fact delivered to close out a different sale. Despite the taxpayer’s intent to use the purchased stock to close his earliest open short sale, and despite a showing that he followed a consistent practice of applying purchases to close out his earliest open short sale, the taxpayer was held not to have closed a short sale because the stock was not actually delivered to the stock lender. Noting that the taxpayer had not entered into any agreement or understanding with the lender of the 7,100 shares and had not otherwise placed himself in a position in which he was not entitled to treat the purchased shares as long stock and sell them for his own account, the court stated:

[The covering shares] remained under control of the taxpayer and up to the time of actual delivery could have been sold and replaced by other purchases in the absence of prior agreement with the lender to use them to make restitution. Such a shifting intent to cover a short sale ought not to be the critical event which would determine gain or loss under a tax statute. It would leave the whole matter of fixing the event to the taxpayer’s own will. We hold that the time of delivery was the time at which the covering transactions must be regarded as closed.

By contrast, in Hope v. Commissioner, 55 T.C. 1020 (1971), aff’d, 471 F.2d 738 (3d Cir.), cert. denied, 414 U.S. 824 (1973), the Tax Court, in determining that a sale had occurred, relied on the seller’s receipt of sales proceeds and the purchaser’s receipt of title and possession of shares without restriction in use. In that case, the taxpayer was the owner of approximately 57% of the common stock of a company that had recently become a publicly traded company, and was having difficulty in disposing of his remaining large block of stock. The taxpayer made an arrangement with an investment bank for a sale at a price that was approximately one half of the price at which the stock was currently trading. Under the arrangement, the investment bank earned its fee by reselling 25% of the block of stock to the general public. The investment bank held the remainder of the stock subject to options to purchase the stock at the investment bank’s cost and subject to proxy agreements that transferred to the optionees the right to vote the shares for the election of directors. Half of the options and proxy rights were held by the taxpayer’s brother; the other half were held by two individuals who were employees of the company. Subsequent to the closing of the transaction, the taxpayer became dissatisfied with the sale price and brought a suit for rescission. The litigation was not concluded in the year of the transaction. On advice of counsel, the taxpayer held the sales proceeds in cash and marketable securities pending settlement of the litigation. On his tax return for the year of the transfer, the taxpayer disclosed the transfer but did not include in income his gain on the sale on the ground that the transfer was not a completed sale on which gain was recognized.

The court concluded that the transaction constituted a sale of the entire block:

The facts of this case conclusively establish that on July 27, 1960, the petitioner sold 206,400 shares of . . . stock to [an investment bank] as agent for several purchasers as well as for its own account. The sale was completed on that date when title and possession of the certificates were transferred by the petitioner to [the investment bank], and the petitioner received $4,000,032 as payment in full. . . . The petitioner received the money from the sale without any restrictions on his use or disposition of those funds.

55 T.C. at 1029.

In the present case, on the Execution Date, Shareholder received a fixed payment without any restriction on its use and also transferred in trust the maximum number of shares that might be required to be delivered under the Agreement. Like the taxpayers in Miami National Bank and Richardson, but unlike the taxpayer in Hope, Shareholder retained the right to receive dividends and exercise voting rights with respect to the pledged shares. Also unlike Hope, the legal title to, and actual possession of, the shares were transferred to an unrelated trustee rather than to Investment Bank. Moreover, Shareholder was not required by the terms of the Agreement to surrender the shares to Investment Bank on the Exchange Date. Rather, Shareholder had a right, unrestricted by agreement or economic circumstances, to reacquire the shares on the Exchange Date by delivering cash or other shares. See Miami National Bank and Richardson. Accordingly, the execution of the Agreement did not cause a sale or other disposition of the shares.

A different outcome may be warranted if a shareholder is under any legal restraint or requirement or under any economic compulsion to deliver pledged shares rather than to exercise a right to deliver cash or other shares. For example, restrictions placed
upon a shareholder’s right to own pledged common stock after the Exchange Date, or an expectation that a shareholder will lack sufficient resources to exercise the right to deliver cash or shares other than pledged shares, would be significant factors to be weighed in determining whether a sale has occurred.

Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale. Under § 1259(b), the term “appreciated financial position” means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value. Furthermore, for purposes of § 1259, the term “position” means an interest, including a futures or forward contract, short sale, or option.

Under § 1259(c)(1)(C), a taxpayer is treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person) enters into a futures or forward contract to deliver the same or substantially identical property. The term “forward contract” is defined under § 1259(d)(1) as a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price. The legislative history indicates that a forward contract that provides for the delivery of an amount of stock that is subject to a significant variation under the terms of the contract is not within the statutory definition of a forward contract. S. Rep. No. 33, 105th Cong., 1st Sess. 125–26 (1997), 1997–4 (Vol. 2) C.B. 1067, 1205–06.

Under these facts, the Agreement does not cause a constructive sale of the shares under § 1259(c)(1)(C). According to the Agreement, delivery of a number of shares, which may vary between 80 and 100 shares, depends on the fair market value of the stock on the Exchange Date. Because this variation in the number of shares that may be delivered under the Agreement is a significant variation, the Agreement is not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1). As a result, the Agreement does not meet the definition of a forward contract under § 1259(d)(1) and does not cause a constructive sale under § 1259(c)(1)(C).

HOLDING

Shareholder has neither sold stock currently nor caused a constructive sale of stock if Shareholder receives a fixed amount of cash, simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that varies significantly depending on the value of the shares on the delivery date, pledges the maximum number of shares for which delivery could be required under the agreement, retains an unrestricted legal right to substitute cash or other shares for the pledged shares, and is not economically compelled to deliver the pledged shares.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Christina Morrison and Mary Truchly of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Ms. Morrison at (202) 622–3950 or Ms. Truchly at (202) 622–3960 (not toll-free calls).

Section 4374.—Liability for Tax

26 CFR 46.4374–1: Liability for tax.

T.D. 9024

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 46

Liability For Insurance Premium Excise Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 4374 relating to liability for the insurance premium excise tax. This document affects persons who make, sign, issue, or sell a policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by any foreign insurer or reinsurer.

DATES: Effective Date: These regulations are effective November 27, 2002.

Applicability Date: These regulations are applicable to premiums paid on or after November 27, 2002.

FOR FURTHER INFORMATION CONTACT: David Lundy at (202) 622–3880 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 7, 2002, the IRS and Treasury published a notice of proposed rulemaking (REG–125450–01, 2002–5 I.R.B. 457) in the Federal Register (67 FR 707) under section 4374 relating to the insurance premium excise tax imposed by section 4371 on certain policies issued by foreign insurance and reinsurance companies. One comment letter responding to the notice of proposed rulemaking was received. After consideration of these comments, the proposed regulations are adopted as final regulations as revised by this Treasury decision.

Explanation of Provisions

These final section 4374 regulations clarify the persons who are liable for payment of the insurance premium excise tax and conform the regulations to the amendments made to section 4374 by the Tax Reform Act of 1976 (90 Stat. 1525). In particular, these regulations clarify that liability for the excise tax is incurred by any person who makes, signs, issues, or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued, or sold.

One commentator suggested that the final regulation restrict application of the section 7270 penalty to a failure to pay the excise tax by the person who remitted the tax to the foreign insurer or reinsurer. Section 46.4374–1(d) of the regulation only is a cross-reference to section 7270, which section imposes a penalty of double the amount of tax when an underpayment re-
results from an intention to evade the tax. Substantive guidance on the application of section 7270 is beyond the scope of this regulation, and accordingly, no change to the regulation was made as a result of this suggestion.

The same commentator suggested that the final regulation clarify whether the insured person under an insurance policy may be liable for the excise tax if all or a portion of the risks from such policy are reinsured with a foreign reinsurer on the basis that the insured may be treated as a person for whose benefit the reinsurance policy was made, signed, issued, or sold. In response to the commentator’s suggestion, §46.4374–1(a) of these regulations has been revised to provide that in the case of a reinsurance policy other than assumption reinsurance, the insured person on the underlying insurance policy, the risk of which is covered in whole or in part by such reinsurance policy, shall not constitute a person for whose use or benefit the reinsurance policy was made, signed, issued or sold. In these cases, when an insurer or reinsurer reinsures a risk with a foreign reinsurer, the insurer or reinsurer generally is the person for whose use or benefit the reinsurance policy is issued or sold for purposes of section 4374.

Effective Date

The final regulations are effective for premiums paid on or after November 27, 2002.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is David Lundy of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 46 is amended as follows:

PART 46 — EXCISE TAX ON POLICIES ISSUED BY FOREIGN INSURERS AND OBLIGATIONS NOT IN REGISTERED FORM

Paragraph 1. The authority citation for part 46 continues to read as follows:


Par. 2. Section 46.4374–1 is revised to read as follows:

§46.4374–1 Liability for tax.

(a) In general. Any person who makes, signs, issues, or sells any of the documents and instruments subject to the tax, or for whose use or benefit the same are made, signed, issued, or sold, shall be liable for the tax imposed by section 4371. For purposes of this section, in the case of a reinsurance policy that is subject to the tax imposed by section 4371(3), other than assumption reinsurance, the insured person on the underlying insurance policy, the risk of which is covered in whole or in part by such reinsurance policy, shall not constitute a person for whose use or benefit the reinsurance policy is made, signed, issued, or sold.

(b) When liability for tax attaches. The liability for the tax imposed by section 4371 shall attach at the time the premium payment is transferred to the foreign insurer or reinsurer (including transfers to any bank, trust fund, or similar recipient, designated by the foreign insurer or reinsurer), or to any nonresident agent, solicitor, or broker. A person required to pay tax under this section may remit such tax before the time the tax attaches if he keeps records consistent with such practice.

(c) Payment of tax. The tax imposed by section 4371 shall be paid on the basis of a return by the person who makes pay-
tion of income tax return preparer under section 7701(a)(36). These final regulations also exclude certain persons who are employed by, or volunteer for, such clinics.

DATES: Effective Date: These regulations are effective December 18, 2002.

Applicability Date: These regulations apply to returns that are prepared on or after December 18, 2002.

FOR FURTHER INFORMATION CONTACT: Brinton T. Warren at (202) 622–4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Regulations on Procedure and Administration (26 CFR part 301) relating to the definition of the term income tax return preparer under section 7701(a)(36) of the Internal Revenue Code (Code). On June 11, 2002, a notice of proposed rulemaking was published in the Federal Register (REG–115285–01, 2002–27 I.R.B. 62 [67 FR 39915]). One comment was received in response to the notice of proposed rulemaking. No public hearing was requested or held. After consideration of the comment, the proposed regulations under section 7701(a)(36) are adopted.

These regulations have been promulgated in furtherance of the purposes of Section 3601(a) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 685) (1998) (RRA 1998), Section 3601(a), which added section 7526 of the Code, provides grants to qualified LITCs. Qualified LITCs represent taxpayers in controversies with the IRS and operate programs to inform individuals for whom English is a second language (ESL taxpayers) about their rights and responsibilities as taxpayers (ESL outreach). Qualified LITCs are either clinical programs run by accredited educational institutions that allow students to represent low-income taxpayers, or tax-exempt organizations that provide representation to low-income taxpayers.


The preparer penalties enacted by TRA 1976 reflect the concern of Congress with improper practices within the commercial tax services industry. See H. R. Rep. No. 94–658, 94th Cong. 1st Sess. 274 (1976), 1976–3 (Vol. 2) C.B. 966. Consistent with the commercial focus of the legislative history, the definition of an income tax return preparer requires that the tax return or claim for refund be prepared “for compensation.” Persons who do not receive compensation are not income tax return preparers for purposes of section 7701(a)(36) regardless of the extent to which they are involved with the preparation of a return or claim for refund.

Under section 7526(b)(1)(A)(i), a qualified LITC may not charge more than a nominal fee for its authorized services (except for reimbursement of actual costs incurred). These final regulations, consistent with the notice of proposed rulemaking, specify the circumstances in which an LITC may receive a nominal fee that will not be considered compensation for purposes of section 7701(a)(36).

Explanation of Revisions and Summary of Comment

These final regulations adopt the proposed amendments without substantive change. Under these final regulations, qualified LITCs, as defined by section 7526, and employees and volunteers of such LITCs, that provide assistance with a tax return or claim for refund will not be treated as income tax return preparers if two requirements are satisfied.

First, any such return preparation assistance must be (i) directly related to a controversy with the IRS for which the LITC is providing assistance or (ii) an ancillary part of an LITC’s ESL outreach program. Second, the LITC cannot charge a separate fee or vary a fee based on whether the LITC provides assistance with a return of tax or claim for refund, or charge more than a nominal fee for its services. The regulations apply to returns prepared on or after December 18, 2002.

The commentator focused on the scope of the direct relation requirement that applies to LITCs that represent taxpayers in controversies. The commentator observed that, for a nonfiler to obtain the benefits of an offer in compromise or installment agreement, it is sometimes necessary for an LITC to prepare a number of the nonfiler’s returns for prior years. The commentator requested clarification as to whether preparation of the prior-year returns is directly related to the nonfiler’s controversy with the IRS. As in the commentator’s example, in cases where the preparation of a taxpayer’s return is required to resolve a controversy for which an LITC is representing a taxpayer, such preparation would be treated under these final regulations as directly related to that controversy.

The regulations do not address the definition of a nominal fee. The Treasury Department and the IRS specifically requested comments on the need for a definition of a nominal fee and the factors that should be considered in defining a nominal fee. No comments were received on this topic. The Treasury Department and the IRS conclude that the definition of nominal fee should not be addressed in these regulations at this time. The final regulations do not specifically address the qualifications of an LITC under section 7526. The Treasury Department and IRS reiterate the view, originally stated in the preamble of the proposed regulations, that a qualified LITC may not provide return preparation assistance other than assistance directly related to a controversy with the IRS or assistance that is an ancillary part of an ESL outreach program.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

The principal author of the regulations
Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * *

Par. 2. Section 301.7701–15 is amended by:
1. Removing the language “and” at the end of paragraph (a)(7)(iii).
2. Removing the period at the end of paragraph (a)(7)(iv) and adding a semicolon in its place.
3. Adding paragraphs (a)(7)(v) through (a)(7)(viii).

The additions read as follows:

§ 301.7701–15 Income tax return preparer.

* * * * *

(a) * * *

(7) * * *

(v) Any individual who provides tax assistance as part of a qualified Low-Income Taxpayer Clinic (LITC), as defined by section 7526, subject to the requirements of paragraphs (a)(7)(vii) and (viii) of this section; and

(vi) Any organization that is a qualified Low-Income Taxpayer Clinic (LITC), as defined by section 7526, subject to the requirements of paragraphs (a)(7)(vii) and (viii) of this section.

(vii) Paragraphs (a)(7)(v) and (vi) of this section apply only if any assistance with a return of tax or claim for refund under subtitle A is directly related to a controversy with the Internal Revenue Service for which the qualified LITC is providing assistance, or is an ancillary part of an LITC program to inform individuals for whom English is a second language about their rights and responsibilities under the Internal Revenue Code.

* * * * *

David A. Mader,
Assistant Deputy Commissioner of Internal Revenue.

Approved December 11, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on December 17, 2002, 8:45 a.m., and published in the issue of the Federal Register for December 18, 2002, 67 F.R. 77418)
Part III. Administrative, Procedural, and Miscellaneous

Section 45D.—New Markets Tax Credit

Notice 2003-9

PURPOSE

The purpose of this notice is to announce that the Treasury Department and Internal Revenue Service will amend § 1.45D–1T(c)(3)(ii) of the temporary Income Tax Regulations to extend a deadline relating to certain equity investments made before the receipt of a new markets tax credit allocation from the Secretary under § 45D(f)(2) of the Internal Revenue Code.

BACKGROUND

Section 45D(a)(1) provides a new markets tax credit on certain credit allowance dates described in § 45D(a)(3) with respect to a qualified equity investment in a qualified community development entity (CDE).

Section 45D(b)(1) provides that an investment in a CDE is a qualified equity investment only if, among other requirements, the CDE designates the investment as a qualified equity investment.

Section 45D(c)(1) provides that an entity is a CDE only if, among other requirements, the entity is certified by the Secretary as a CDE.

Section 45D(b)(2) provides that the maximum amount of equity investments issued by a CDE that may be designated by the CDE as qualified equity investments shall not exceed the portion of the new markets tax credit limitation set forth in § 45D(f)(1) that is allocated to the CDE by the Secretary under § 45D(f)(2).

Section 1.45D–1T(c)(3)(i) provides that, except as provided in § 1.45D–1T(c)(3)(ii), an equity investment in an entity is not eligible to be designated as a qualified equity investment if it is made before the entity enters into an allocation agreement with the Secretary. An “allocation agreement” is an agreement between the Secretary and a CDE relating to a new markets tax credit allocation under § 45D(f)(2).

The Secretary under § 45D(c) before January 1, 2003; (C) the entity in which the equity investment is made receives notification of the credit allocation (with the actual receipt of such credit allocation contingent upon subsequently entering into an allocation agreement) from the Secretary before January 1, 2003; and (D) the equity investment otherwise satisfies the requirements of § 45D and § 1.45D–1T.

The Secretary of the Treasury Department has delegated certain administrative functions relating to the new markets tax credit program to the Under Secretary (Domestic Finance), who in turn has delegated those functions to the Community Development Financial Institutions Fund (CDFI Fund). The delegated administrative functions include CDE certifications and new markets tax credit allocations.

The CDFI Fund published a Notice of Allocation Availability (NOAA) in the Federal Register on June 11, 2002 (67 FR 40112) covering, among other things, how an entity applies for an allocation under § 45D(f)(2). The NOAA set a deadline for receiving all allocation applications (electronic and written) of no later than 5 p.m. ET on August 29, 2002.

DISCUSSION

The CDFI Fund will not complete new markets tax credit allocations before January 1, 2003. Accordingly, the Treasury Department and Service intend to amend § 1.45D–1T(c)(3)(i) to provide that, notwithstanding § 1.45D–1T(c)(3)(i), an equity investment in an entity is eligible to be designated as a qualified equity investment under § 1.45D–1T(c)(1)(iii) if:

1. The equity investment is made on or after April 20, 2001;
2. The designation of the equity investment as a qualified equity investment is made for a credit allocation received pursuant to an allocation application submitted to the CDFI Fund no later than August 29, 2002; and
3. The equity investment otherwise satisfies the requirements of § 45D and § 1.45D–1T.

The temporary regulations will be revised to incorporate the guidance set forth in this notice. The revision to the temporary regulations reflecting this notice will be effective for equity investments made on or after April 20, 2001.

DRAFTING INFORMATION

The principal author of this notice is Paul Handleman of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Handleman at (202) 622–3040 (not a toll-free call).

Definition of Early Retirement Benefit and Retirement-Type Subsidy

Notice 2003-10

I. PURPOSE

The Internal Revenue Service and the Treasury Department intend to propose regulations that would provide guidance on benefits that are treated as early retirement benefits and retirement-type subsidies for purposes of § 411(d)(6)(B) of the Internal Revenue Code. It is expected that the regulations would include guidance resolving conflicting court decisions that address the extent to which payments that are contingent on the occurrence of an unpredictable event, such as a plant shutdown, are protected under § 411(d)(6)(B). The Service and Treasury invite comments on possible approaches before regulations are proposed.

II. BACKGROUND

Section 411(d)(6) generally provides that a plan is not treated as satisfying the requirements of § 411 if the accrued benefit of a participant is decreased by a plan amendment. Under § 411(d)(6)(B), a plan amendment that has the effect of eliminating or reducing a retirement-type subsidy, with respect to benefits attributable to service before the amendment, is treated as reducing accrued benefits for any employee who satisfies the pre-amendment conditions for the subsidy (either before or after the amendment). In addition, a plan amendment that has the effect of eliminating an early retirement benefit or, except as
provided in regulations, an optional form of benefit is treated as reducing accrued benefits. Further, Treas. Reg. § 1.411(d)-4, Q&A–1(d) specifies benefits that are ancillary and thus not protected from reduction or elimination under § 411(d)(6)(B).

Section 645(b) of the Economic Growth and Tax Reform Reconciliation Act of 2001 (EGTRRA) amended § 411(d)(6)(B) to provide for the Secretary of Treasury to issue regulations permitting the elimination of benefits or subsidies that create significant burdens or complexities for the plan and plan participants, and that affect the rights of any participant in no more than a de minimis manner. In Notice 2002–46, 2002–28 I.R.B. 96, the Service and Treasury requested comments in advance of developing regulations implementing the EGTRRA amendment.


Section § 411(d)(6)(B) was added to the Code by § 301 of the Retirement Equity Act of 1984 (REA), Pub. L. No. 98–387, 98 Stat. 1426, 1450–51 (1984). With respect to retirement-type subsidies, the legislative history relating to § 301 of REA states, in part:

The bill provides that an amendment of a qualified plan is to be treated as reducing accrued benefits if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

The bill provides that the term “retirement-type subsidy” is to be defined by Treasury regulations. The committee intends that under these regulations, a subsidy that continues after retirement is generally to be considered a retirement-type subsidy. The committee expects, however, that a qualified disability benefit, a medical benefit, a social security supplement, a death benefit (including life insurance), or a plant shutdown benefit (that does not continue after retirement age) will not be considered a retirement-type subsidy. The committee expects that Treasury regulations will prevent the recharacterization of retirement-type benefits as benefits that are not protected by the provision.


Questions have arisen as to whether a benefit that is contingent on the occurrence of an unpredictable event, such as a plant shutdown or an involuntary separation, is a retirement-type subsidy and, thus, protected by § 411(d)(6). Since the enactment of REA, three circuit courts have held that an unpredictable contingent event benefit is protected, while one has held that it is not. Compare Bellas v. CBS, Inc., 221 F.3d 517 (3rd Cir. 2000), cert. denied, 531 U.S. 1104 (2001) (separation benefit is both an early retirement benefit and a retirement-type subsidy); Richardson v. Pension Plan of Bethlehem Steel Corp., 67 F.3d 1462 (9th Cir. 1995), withdrawn, 91 F.3d 1312 (9th Cir. 1996), modified, 112 F.3d 982 (9th Cir. 1997) (shutdown benefit is a retirement-type subsidy protected under anticutback rule, opinion withdrawn and modified because court later found plan amendment not valid), and Harms v. Cavenham Forest Industries, Inc., 984 F.2d 686 (5th Cir.), cert. denied, 510 U.S. 944 (1993) (involuntary separation benefit is a retirement-type benefit protected under the anticutback rule), with Ross v. Pension Plan for Hourly Employees of SKF Industries, Inc., 847 F.2d 329 (6th Cir. 1988) (plant shutdown benefit is not a retirement-type subsidy).

III. UPCOMING PROPOSED REGULATIONS

The Service and Treasury anticipate that upcoming proposed regulations will provide general guidance concerning early retirement benefits and retirement-type subsidies under § 411(d)(6)(B). The upcoming proposed regulations are expected to address whether benefits that are contingent on the occurrence of certain events, such as plant shutdown or involuntary separation, and that continue beyond normal retirement age, are retirement-type subsidies that are protected under § 411(d)(6)(B) both before and after the occurrence of the contingency. In addition, the upcoming proposed regulations are expected to address the question of whether payment of the accrued benefit at an early commencement date on an unreduced or partially subsidized basis will be treated as providing a benefit that continues beyond normal retirement age and, hence, would be considered to be a retirement-type subsidy.

Section § 411(d)(6) does not restrict the ability of an employer to amend a plan to eliminate accruals, subsidies, or other benefits (whether or not contingent), with respect to benefits not yet accrued. Thus, for example, the anticipated proposed regulations would not restrict an employer from amending a plan to compute the subsidized portion of the contingent benefit based solely on service completed before the date of the amendment, or to limit the benefit payable under the retirement-type subsidy to the amount payable as of the date of the amendment. In addition, because § 411(d)(6) does not prevent an employer from amending a plan to eliminate ancillary benefits, the anticipated proposed regulations would not restrict a plan amendment to eliminate contingent benefits that are ancillary benefits. Thus, the anticipated proposed regulations would not restrict a plan amendment to eliminate an ancillary benefit described in Treas. Reg. § 1.411(d)-4, Q&A–1(d) (e.g., a social security supplement that is not a qualified social security supplement under § 1.401(a)(12)), regardless of whether the amendment occurs before or after the occurrence of any contingency on which the benefit is based.

IV. REGULATIONS WILL BE PROSPECTIVE

The regulations described above will be prospective. Regardless of the position taken in the final regulations, the Service will not treat a plan as failing to satisfy the requirements of §§ 401 and 411 merely because of a plan amendment that eliminates or reduces an early retirement benefit or retirement-type subsidy that is conditioned on the occurrence of an unpredictable contingent event (within the meaning of section § 412(j)) if the amendment is adopted and effective prior to the occurrence of the contingent event and prior to the publica-
tion of final regulations addressing this issue in the Federal Register. Note, however, that it is clear under current law that such a plan amendment is prohibited under § 411(d)(6) and § 411(a) (which provides vesting requirements for accrued benefits and prohibits forfeiture of a vested accrued benefit) if the amendment is adopted or effective after the occurrence of the contingent event.

V. COMMENTS REQUESTED

Comments regarding the anticipated proposed regulations described in this notice are requested, including comments on the guidance that should be provided regarding early retirement benefits and retirement-type subsidies. In addition, comments are requested on the extent to which such proposed regulations should include relief for amendments that eliminate or reduce early retirement benefits or retirement-type subsidies that are contingent on unpredictable events, that create significant burdens or complexities for the plan and plan participants, and that affect the rights of any participant in no more than a de minimis manner. Comments should be submitted by May 5, 2003, to CC:ITA:RU (Notice 2003–10), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m., Monday through Friday to CC:ITA:RU (Notice 2003–10), Courier’s Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington D.C. Alternatively, comments may be submitted via the Internet at Notice.Comments@irs counsel.treas.gov. All comments will be available for public inspection.

VI. EFFECT ON OTHER DOCUMENTS

Notice 2002–46 is modified.

DRAFTING INFORMATION

The principal authors of this notice are Preston Rutledge of the Office of the Associate Chief Counsel (Tax Exempt and Government Entities) and Diane S. Bloom of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday by calling 1–877–829–5500 (a toll-free number). Mr. Rutledge can be reached at (202) 622–6090 and Ms. Bloom can be reached at (202) 283–9888 (not toll-free numbers).

26 CFR 601.106: Appeals functions. (Also Part I, §§ 6015; 1.6015–6.)


SECTION 1. PURPOSE

This revenue procedure provides guidance on the administrative appeal rights of a spouse or former spouse when a taxpayer seeks relief from federal income tax liability under section 6015 of the Internal Revenue Code.

SECTION 2. BACKGROUND

01 Section 6013(d)(3) provides that married taxpayers who file a joint return under section 6013 will be jointly and severally liable for the tax arising from that return. For purposes of section 6013(d)(3) and this revenue procedure, the term “tax” includes penalties, additions to tax, and interest. See sections 6665(a)(2) and 6601(e)(1).

02 Section 6015 provides relief in certain circumstances from the joint and several liability imposed by section 6013(d)(3). For purposes of this revenue procedure, the individual seeking relief from federal income tax liability under section 6015 is referred to as a “requesting spouse” and the individual with whom the requesting spouse filed the joint return is referred to as a “nonrequesting spouse.”

03 To request relief under section 6015, a requesting spouse must file a Form 8857, “Request for Innocent Spouse Relief,” or a written statement with the Internal Revenue Service signed under penalties of perjury, containing the same information required on Form 8857.

04 Prior to publication of this revenue procedure, only the requesting spouse had the right to file a written protest and receive an administrative conference with the Service’s Appeals Office (an “Appeals conference”). The Service has determined that the nonrequesting spouse may file a written protest and receive an Appeals conference with respect to the Service’s decision to grant partial or full relief to the requesting spouse. The nonrequesting spouse may not, however, appeal a decision by the Service to deny relief to the requesting spouse.

05 In section 6015(h)(2), Congress expressed its intent that the nonrequesting spouse have notice of, and be involved in, proceedings with respect to a section 6015 election made by the requesting spouse. The nonrequesting spouse has (with respect to the Service or the Tax Court, as the case may be) the following opportunities to participate in the determination of whether the requesting spouse is entitled to relief under section 6015:

(1) As required by section 6015(h)(2) and section 1.6015–6 of the Income Tax Regulations, the Service notifies the nonrequesting spouse of the requesting spouse’s claim for relief and provides the nonrequesting spouse with an opportunity to submit information to be considered by the Service in its administrative determination. The nonrequesting spouse is not required to provide information. The Service will consider all relevant information submitted by the requesting spouse and the nonrequesting spouse in determining whether to grant or deny relief.

(2) Once the Service notifies the requesting spouse and the nonrequesting spouse of the preliminary determination regarding the requesting spouse’s claim for relief, the requesting spouse, the nonrequesting spouse, or both spouses may file a protest and receive an Appeals conference as set forth in section 4 of this revenue procedure.

(3) Section 6015(e)(1)(A) allows the requesting spouse to petition the Tax Court from a notice of final determination. There are no provisions in section 6015 that allow the nonrequesting spouse to petition the Tax Court from a notice of final determination. See Maier v. Commissioner, 119 T.C. 267 (2002). If, however, the requesting spouse petitions the Tax Court, section 6015(e)(4) and the Tax Court’s Rules allow the nonrequesting spouse to become a party to the proceeding.

SECTION 3. SCOPE

This revenue procedure applies to a nonrequesting spouse who appeals the preliminary determination granting full or partial relief from joint and several liability to a requesting spouse.
SECTION 4. GENERAL PROCEDURES

.01 Initial proceedings following a requesting spouse’s claim for relief under section 6015. In general, the Service will follow the procedures below after making a preliminary determination regarding a claim for relief from joint and several liability:

(1) The Service will issue a preliminary determination letter to the requesting spouse based on the merits of the claim. In the event the preliminary determination grants full or partial relief, the Service will suspend processing of the claim for 45 calendar days, pending an appeal by the nonrequesting spouse. The Service will notify the requesting spouse that the nonrequesting spouse has the right to separately protest the Service’s preliminary determination.

(2) The Service will notify the nonrequesting spouse of the preliminary determination at the same time the Service notifies the requesting spouse. The nonrequesting spouse has the right to file a written protest requesting an Appeals conference to protest the preliminary determination. To be eligible for an Appeals conference, the nonrequesting spouse must request an Appeals conference, in writing, within 30 calendar days of the mailing date of the notification letter. If the nonrequesting spouse appeals, the Service will suspend further processing of the requesting spouse’s claim for relief pending the outcome of the nonrequesting spouse’s appeal.

.02 Procedures for cases forwarded to Appeals. The following procedures will apply to Appeals conferences for section 6015 claims for relief:

(1) If, after the Service issues a preliminary determination letter to the requesting spouse, only the nonrequesting spouse files a written protest requesting an Appeals conference, the Service will notify the requesting spouse of the nonrequesting spouse’s request for an Appeals conference. The Service will hold an Appeals conference with the nonrequesting spouse. If Appeals proposes to change the preliminary determination, the requesting spouse will have an opportunity to request an Appeals conference to present his or her position including any relevant information before the final determination.

(2) If, after the Service issues a preliminary determination letter to the requesting spouse, only the requesting spouse files a written protest requesting an Appeals conference, the Service will notify the nonrequesting spouse of the requesting spouse’s request for a conference. The Service will hold an Appeals conference with the requesting spouse. If Appeals proposes to increase the relief recommended in the preliminary determination letter, the nonrequesting spouse will have an opportunity to request an Appeals conference to present his or her position including any relevant information before the final determination.

(3) If, after the Service issues a preliminary determination letter to the requesting spouse, both spouses file written protests requesting Appeals conferences, the Service will notify each spouse of the other spouse’s request for an Appeals conference. The Service will hold separate Appeals conferences with each spouse, with both spouses permitted to submit information. The Service, in its discretion, may hold a joint Appeals conference instead of separate Appeals conferences.

(4) Appeals conferences may be conducted by telephone, correspondence, face-to-face meetings or by a combination of these methods.

.03 Procedures after Appeals has made a determination. Upon reaching a final decision, Appeals will:

(1) Issue the notice of final determination to the requesting spouse, unless the requesting spouse executes a waiver pursuant to section 6015(e)(5); and

(2) Notify the nonrequesting spouse of the final determination.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for all claims for relief filed on or after April 1, 2003. In addition, this revenue procedure applies to any claims for relief filed prior to April 1, 2003, for which no preliminary determination has been issued as of April 1, 2003.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Jamie P. MacLean of the Office of the Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). For further information regarding this revenue procedure, contact Elvira Bosco of Appeals at (212) 298–2272 (not a toll-free call) or a local Appeals office.
Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Regarding Deduction and Capitalization of Expenditures

REG-125638-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire, create, or enhance intangible assets. This document also contains proposed regulations under section 167 of the Code that provide safe harbor amortization for certain intangible assets, and proposed regulations under section 446 of the Code that explain the manner in which taxpayers may deduct debt issuance costs. Finally, this document provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by March 19, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for April 22, 2003, must be received by April 1, 2003.

ADDRESSES: Send submissions to CC:ITA:RU (REG–125638–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:ITA:RU (REG–125638–01), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically via the IRS Internet site at: www.irs.gov/regs. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Andrew J. Keyso, (202) 927–9397; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In recent years, much debate has focused on the extent to which section 263(a) of the Code requires taxpayers to capitalize amounts paid to acquire, create, or enhance intangible assets. On January 24, 2002, the IRS and Treasury Department published an advance notice of proposed rulemaking (ANPRM) in the Federal Register (67 FR 3461) announcing an intention to provide guidance in this area. The ANPRM described and explained rules under consideration by the IRS and Treasury Department and invited public comment on these rules.

Explanation of Provisions

I. Introduction

The proposed regulations under section 263(a) of the Code set forth a general principle that requires capitalization of certain amounts paid to acquire, create, or enhance intangible assets. In addition, the proposed regulations identify specific intangible assets for which capitalization is required under the general principle. These identified intangible assets are grouped into categories in the proposed regulations based on whether the intangible asset is acquired from another party or created by the taxpayer.

The proposed regulations also provide rules for determining the extent to which taxpayers must capitalize transaction costs that facilitate the acquisition, creation, or enhancement of intangible assets or that facilitate certain restructurings, reorganizations, and transactions involving the acquisition of capital. These transaction cost rules allow for the use of simplifying conventions intended to promote administrability and reduce the cost of compliance with section 263(a). In addition, the proposed regulations under section 167 of the Code provide a safe harbor amortization period applicable to certain created intangible assets that do not have readily ascertainable useful lives and for which an amortization period is not otherwise prescribed or prohibited by the Code, regulations, or other published guidance.

As a general rule, the proposed regulations are not intended to apply to a taxpayer’s intangible interest in land. Thus, the proposed regulations do not apply to amounts paid to acquire or create easements, life estates, mineral interests, timber rights, or other intangible interests in land. An exception is made for amounts paid to acquire, create, or enhance a lease of real property. Several rules contained in the proposed regulations address amounts paid to acquire, create, or enhance leases of property, including leases of real property. The IRS and Treasury Department are considering future guidance addressing the treatment of amounts paid to acquire, create, or enhance tangible assets. Appropriate rules relating to the treatment of interests in land will be addressed in that future guidance.

II. General Principle of Capitalization

A. Overview

The proposed regulations require capitalization of amounts paid to acquire, create, or enhance an intangible asset. For this purpose, an intangible asset is defined as (1) any intangible that is acquired from another person in a purchase or similar transaction (as described in paragraph (c) of the proposed regulations); (2) certain rights, privileges, or benefits that are created or originated by the taxpayer and identified in paragraph (d) of the proposed regulations; (3) a separate and distinct intangible asset (as defined in paragraph (b)(3) of the proposed regulations); or (4) a future benefit that the IRS and Treasury Department identify in subsequent published guidance as an intangible asset for which capitalization is required. As discussed in Part V of this preamble, the proposed regulations also require capitalization of transaction costs that facilitate the acquisition, creation, or enhancement of an intangible asset or that facilitate a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, such as a stock issuance, borrowing, or recapitalization.

Through this definition of intangible asset, the IRS and Treasury Department seek to provide certainty for taxpayers by identifying specific categories of rights, privi-
leges, and benefits, the costs of which are appropriately capitalized. In determining the categories of expenditures for which capitalization is specifically required, the IRS and Treasury Department considered expenditures for which the courts have traditionally required capitalization. These categories will help promote consistent interpretation of section 263(a) by taxpayers and IRS field personnel.

B. Separate and distinct intangible asset

The proposed regulations define the term “separate and distinct intangible asset” based on factors traditionally used by the courts to determine whether an expenditure serves to acquire, create, or enhance a separate and distinct asset. Courts have considered (1) whether the expenditure creates a distinct and recognized property interest subject to protection under state or federal law; (2) whether the expenditure creates anything transferrable or salable; and (3) whether the expenditure creates anything with an ascertainable and measurable value in money’s worth. See, e.g., Commissioner v. Lincoln Savings & Loan Ass’n, 403 U.S. 345, 355 (1971); Central Texas Savings & Loan Ass’n v. United States, 731 F.2d 1181, 1184 (5th Cir. 1984); Colorado Springs National Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 784 (2nd Cir. 1973).

The proposed regulations provide that the determination of whether an amount serves to acquire, create, or enhance a separate and distinct intangible asset is made as of the taxable year during which the amount is paid, and not later using the benefit of hindsight.

The IRS and Treasury Department note that the separate and distinct asset standard has not historically yielded the same level of controversy as the significant future benefit standard. Moreover, several commentators suggested that, if the proposed regulations adopt a general principle of capitalization, the separate and distinct asset test is a workable principle in practice.

C. Significant future benefits identified in published guidance

A fundamental purpose of section 263(a) is to prevent the distortion of taxable income through current deduction of expenditures relating to the production of income in future years. Thus, in determining whether an expenditure should be capitalized, the Supreme Court has considered whether the expenditure produces a significant future benefit. INDOPOCO, Inc. v. Commissioner, 503 U.S. 79 (1992). A “significant future benefit” standard, however, does not provide the certainty and clarity necessary for compliance with, and sound administration of, the law. Consequently, the IRS and Treasury Department believe that simply restating the significant future benefit test, without more, would lead to continued uncertainty on the part of taxpayers and continued controversy between taxpayers and the IRS. Accordingly, the IRS and Treasury Department have initially defined the exclusive scope of the significant future benefit test through the specific categories of intangible assets for which capitalization is required in the proposed regulations. The future benefit standard underlies many of these categories.

The IRS and Treasury Department recognize, however, that there may be expenditures that are not identified in these categories, but for which capitalization is nonetheless appropriate. For this reason, the proposed regulations require capitalization of non-listed expenditures if those expenditures serve to produce future benefits that the IRS and Treasury Department identify in published guidance as significant enough to warrant capitalization. A determination in published guidance that a particular category of expenditure produces a benefit for which capitalization is appropriate will apply prospectively, and will not apply to expenditures incurred prior to the publication of such guidance.

For purposes of future guidance, the IRS and Treasury Department will determine whether capitalization is appropriate for a particular category of expenditures by taking into account all relevant facts and circumstances, including the probability, measurability, and size of the expected future benefit. Such published guidance may provide a safe harbor amortization period for any expenditure required to be capitalized. If the published guidance does not provide a safe harbor amortization period, the expenditure may be eligible for the 15-year safe harbor amortization period described in Part VII.A. of this preamble.

The IRS and Treasury Department believe that, by applying the significant future benefit test in the manner described above, the proposed regulations will substantially reduce the burden on both taxpayers and IRS field personnel of determining whether an expenditure produces significant future benefits for which capitalization is required. If an expenditure is not described in one of the categories in the proposed regulations or in subsequent future guidance, taxpayers and IRS field personnel need not determine whether that expenditure produces a significant future benefit. Upon finalization of the proposed regulations, the IRS expects to identify and withdraw existing capitalization guidance that is susceptible to application inconsistent with these regulations.

III. Intangibles Acquired From Another

Paragraph (c) of the proposed regulations requires capitalization of amounts paid to another party to acquire an intangible from that party in a purchase or similar transaction. This rule reflects well-settled law requiring capitalization of the purchase price (including sales taxes and similar charges) paid to acquire property from another. The regulations provide examples of intangibles that must be capitalized under this rule if the intangible is acquired from another person. Many of the intangibles required to be capitalized by this rule constitute “amortizable section 197 intangibles” eligible for a 15-year amortization under section 197(a).

The rule does not address the treatment of any transaction costs the taxpayer may incur to facilitate the acquisition of an intangible from another party. The treatment of transaction costs is described in paragraph (e) of the proposed regulations. So, for example, while this rule requires capitalization of the amount paid to another party to acquire an intangible from that party, this rule does not describe the treatment of the various ancillary costs such as attorney fees and broker commissions incurred to facilitate the acquisition.

In addition, the rule applies only to acquired intangibles, and not to created intangibles. For example, the rule requires a taxpayer to capitalize the amount paid to acquire a customer base from another person. However, the rule does not require a taxpayer to capitalize costs that it incurs to create its own customer base.
IV. Created Intangibles

Paragraph (d) of the proposed regulations requires taxpayers to capitalize amounts paid to another party to create or enhance with that party certain identified intangibles discussed in Parts IV.A. through IV.H. of this preamble. Examples are included to demonstrate the scope of these rules.

To reduce the administrative and compliance costs associated with capitalizing these amounts, the proposed regulations adopt a “12-month rule” applicable to most created intangibles. Under this 12-month rule, a taxpayer is not required to capitalize amounts that provide benefits of a relatively brief duration. The 12-month rule is discussed in further detail in Part VI of this preamble.

As in the case of acquired intangibles, the rules in paragraph (d) relating to created intangibles address the amounts paid for the intangible itself, and not the related transaction costs incurred to facilitate the creation of the intangible. The treatment of transaction costs is described in paragraph (e) of the proposed regulations.

A. Financial interests

The proposed regulations require taxpayers to capitalize amounts paid to another party to create or originate with that party certain financial interests. The financial interests identified in the rule include interests in entities (e.g., corporations, partnerships, trusts) and financial instruments (e.g., debt instruments, notional principal contracts, options).

The 12-month rule does not apply to amounts paid to create or enhance a financial interest described in this rule, regardless of whether the amounts are also described in another part of paragraph (d) of the proposed regulations.

B. Prepaid expenses

In general, existing law requires capitalization of prepaid expenses. See, e.g., Commissioner v. Boylston Market Ass’n, 131 F.2d 966 (1st Cir. 1942). The proposed regulations require capitalization of amounts prepaid for benefits to be received in the future. The proposed regulations modify slightly the rule contained in the ANPRM, which proposed capitalization of “amounts prepaid for goods, services, or other benefits (such as insurance) to be received in the future.” The reference to “goods” in the ANPRM caused some readers to question whether the proposed rule is intended to apply to the acquisition of tangible property. The rule is not intended to apply to the acquisition of tangible property. The rule proposes capitalization of prepaid expenses on the ground that the prepayment creates an intangible asset in the form of a right; specifically, the right to receive goods, services, or other benefits in the future. The IRS and Treasury Department decided to eliminate further confusion by modifying the rule to remove the explicit reference to goods.

Further, the reference in the rule to “benefits to be received in the future” is not intended to imply a form of “significant future benefit” test applicable to any expenditure that can be expected to result in some future benefit. As demonstrated by examples in the proposed regulations, the rule is intended merely to require capitalization of prepaid expenses.

C. Amounts paid to obtain certain memberships and privileges

The proposed regulations require taxpayers to capitalize amounts paid to an organization to obtain or renew a membership or privilege from that organization. The rule clarifies that amounts paid to obtain a quality certification of the taxpayer’s products, services, or business processes are not within the scope of the rule. Thus, for example, the rule does not require capitalization of amounts paid to obtain benefits such as ISO 9000 certification or Underwriters’ Laboratories Listing.

D. Amounts paid to obtain certain rights from a governmental agency

The proposed regulations require taxpayers to capitalize amounts paid to a governmental agency for a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency. In general, this rule is directed at the initial fee paid to a government agency. Under the 12-month rule, taxpayers are not required to capitalize annual renewal fees paid to the government agency. An example in the proposed regulations demonstrates this point.

These regulations do not affect the treatment of expenditures under other provisions of the Code. Accordingly, an amount paid to a government agency to obtain a patent from that agency is not required to be capitalized under this section if the amount is deductible under section 174.

E. Amounts paid to obtain or modify contract rights

The proposed regulations require taxpayers to capitalize amounts (other than de minimis amounts) paid to another party to induce that party to enter into, renew, or renegotiate an agreement that produces certain rights for the taxpayer. This rule recognizes that some agreements produce contract rights that are reasonably certain to produce future benefits for the taxpayer, or for which courts have traditionally required capitalization. For example, the rule requires capitalization of amounts paid to enter into or renegotiate a lease contract or a contract providing the taxpayer the right to acquire or provide services. The rule also requires capitalization of an amount paid to obtain a covenant not to compete. Recognizing that employment contracts often are entered into along with covenants not to compete, the proposed regulations contain a rule similar to that in § 1.197–2(b)(9) of the regulations. An agreement for the performance of services does not have substantially the same effect as a covenant not to compete and, accordingly, amounts paid for personal services actually rendered are not required to be capitalized under this rule.

On the other hand, the rule recognizes that many agreements do not produce contract rights for which capitalization is appropriate. Thus, the rule does not require a taxpayer to capitalize an amount that merely creates an expectation that a customer or supplier will maintain its business relationship with the taxpayer.

The rule contains a de minimis exception under which inducements that do not exceed $5,000 are not required to be capitalized. The IRS and Treasury Department request comments on whether a non-cash inducement is properly valued at the taxpayer’s cost to acquire or produce the inducement, or at the fair market value of the inducement. If the non-cash inducement is properly valued at its fair market value, comments are requested regarding the treatment of any gain or loss realized on the transfer of the non-cash inducement.

This rule and the financial interests rule (described in Part IV.A. of this preamble) are the exclusive capitalization provisions.
for created contracts. In other words, amounts paid to enter into an agreement not identified in these rules are not required to be capitalized under the general principle of capitalization on the theory that the agreement is a separate and distinct intangible asset.

F. Amounts paid to terminate certain contracts

The proposed regulations require taxpayers to capitalize an amount paid to terminate three types of contracts. The purpose of the rule is to require capitalization of termination payments that enable the taxpayer to reacquire some valuable right it did not possess immediately prior to the termination. Thus, capitalization is required for payments by a lessor to terminate a lease agreement with a lessee. See Peerless Weighing and Vending Machine Corp. v. Commissioner, 52 T.C. 850 (1969). Capitalization also is required for payments by a taxpayer to terminate an agreement that provides another party the exclusive right to acquire or use the taxpayer’s property or services or to conduct the taxpayer’s business. See Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974). Finally, capitalization is required for payments to terminate an agreement that prohibits the taxpayer from competing with another or from acquiring property or services from a competitor of another.

On the other hand, the rule does not require capitalization in cases where the taxpayer, as a result of the termination, does not reacquire a right for which capitalization is appropriate. For example, the rule does not require a taxpayer to capitalize a payment to terminate a supply contract with a supplier, and does not require a lessee to capitalize a payment to terminate a lease agreement with a lessor. This also is consistent with existing law. See, e.g., Stuart Co. v. Commissioner, 195 F.2d 176 (9th Cir. 1952), aff’d 9 T.C.M. (CCH) 585 (1950); Olympia Harbor Lumber Co. v. Commissioner, 30 B.T.A. 114 (1934), aff’d, 79 F.2d 394 (9th Cir. 1935); Denholm & McKay Co. v. Commissioner, 2 B.T.A. 444 (1925); Rev. Rul. 69–511, 1969–2 C.B. 24.

The proposed regulations modify, in several respects, the rule described in the ANPRM. First, the proposed regulations expand the rule to require capitalization of an amount paid to terminate a contract that grants another the exclusive right to acquire or use the taxpayer’s property or services. Thus, a taxpayer must capitalize amounts paid to terminate an exclusive license to use the taxpayer’s property. Second, the proposed regulations remove the reference to a defined geographic area from the rule requiring capitalization of amounts paid to terminate an agreement that provides another party the exclusive right to conduct the taxpayer’s business. The IRS and Treasury Department are concerned that this reference may lead to uncertainty regarding whether the parties intended for a particular right to be limited to a defined geographic area, especially where the agreement is silent regarding geographic area. Third, as discussed above, the proposed regulations require a taxpayer to capitalize an amount paid to another to terminate an agreement that prohibits the taxpayer from competing with another.

G. Amounts paid to acquire, produce, or improve real property owned by another

The proposed regulations require taxpayers to capitalize an amount paid to acquire real property that is relinquished to another, or to produce or improve real property that is owned by another, if the real property is reasonably expected to produce significant economic benefits for the taxpayer. The purpose of this rule is to recognize a long line of cases and rulings that require capitalization where the taxpayer provides property to another or improves property of another with the expectation that the property will provide significant future benefits for the taxpayer. See D. Love- man & Son Export Corp. v. Commissioner, 34 T.C. 776 (1960), aff’d 296 F.2d 732 (6th Cir. 1961) (expenditures incurred by the taxpayer to pave a public road benefitted the taxpayer’s business and were appropriately capitalized); Chicago and N.W. Railway Co. v. Commissioner, 39 B.T.A. 661 (1939) (conveyance of land by a railroad to a city for highway purposes, the effect of which is of lasting benefit by way of flood protection, access to city streets, and reduced cost of crossing protection is a capital expenditure); Kauai Terminal Ltd. v. Commissioner, 36 B.T.A. 893 (1937) (expenditures incurred by the taxpayer to construct a publicly owned breakwater for the purpose of improving the taxpayer’s freight lighterage operation are capital expenditures); Rev. Rul. 69–229, 1969–1 C.B. 86 (expenditures incurred by a railroad company for construction of a state-owned highway bridge over its tracks create a long term business benefit for the taxpayer and are therefore capital expenditures); Rev. Rul. 66–71, 1966–1 C.B. 44 (expenditures incurred by the taxpayer for dredging to deepen the portion of a harbor alongside the taxpayer’s pier leading to a navigable channel are capital expenditures).

The proposed regulations limit the scope of the rule to real property, and not to all tangible property as originally contemplated by the ANPRM. Some courts have required capitalization on the ground that an intangible asset is created where the taxpayer provides tangible personal property to another. See, e.g., Alabama Coca-Cola Bottling Co. v. Commissioner, T.C. Memo. 1969–123 (capitalization required for costs incurred by a wholesaler to provide signs, scoreboards, and clocks bearing its product logo to retail outlets; the expenditure created valuable benefits that would benefit the taxpayer beyond the taxable year). Nonetheless, the IRS and Treasury Department are reluctant to extend the rule to cases involving tangible personal property. Inclusion of personal property within the scope of the rule would require capitalization of many expenditures that are properly deductible under current law, such as advertising or business promotion costs.

The proposed regulations clarify that the rule is not intended to apply where the taxpayer is selling the real property, is providing the real property to another as payment for some other property or service provided to the taxpayer, or is selling services to produce or improve the property. The proposed regulations also clarify that the rule is not intended to change the result in Rev. Rul. 2002–9, 2002–10 I.R.B. 614, regarding the treatment of impact fees paid by a developer of real property. Rev. Rul. 2002–9 provides that impact fees incurred by a taxpayer in connection with the construction of real property are capitalized costs allocable to the real property. The proposed regulations provide that these costs do not create an intangible asset for which capitalization is required by this rule. Similarly, the proposed regulations provide that real property turned over to a government entity in connection with a real estate development project (dedicated improvements) also are outside the scope of this rule. Such costs are allocable to the prop-
V. Transaction Costs

A. In general

The proposed regulations provide a two-pronged rule that requires taxpayers to capitalize transaction costs. The first prong of the rule requires capitalization of transaction costs that facilitate the taxpayer’s acquisition, creation, or enhancement of an intangible asset. The second prong of the rule requires capitalization of transaction costs that facilitate the taxpayer’s restructuring or reorganization of a business entity or facilitate a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.

The first prong of the transaction cost rule recognizes that capitalization is required not only for the cost of an asset itself, but for the ancillary expenditures incurred in acquiring, creating, or enhancing the intangible asset. Woodward v. Commissioner, 397 U.S. 572 (1970). The proposed regulations require that taxpayers capitalize these transaction costs to the basis of the intangible asset acquired, created, or enhanced.

The second prong of the transaction cost rule recognizes that transaction costs that effect a change in the taxpayer’s capital structure create betterments of a permanent or indefinite nature and are appropriately capitalized. See INDOPOCO, Inc. v. Commissioner, 503 U.S. 79 (1992) (professional fees incurred by a target corporation in a stock acquisition); General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964) (costs to issue a stock dividend to shareholders); Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2nd Cir. 1953) (professional fees incurred in a recapitalization). As discussed in further detail in Part VII of this preamble (relating to safe harbor amortization), the proposed regulations do not address whether these costs increase the taxpayer’s basis in property or are treated as a separate intangible asset. Comments are requested on these issues. However, in the case of transaction actions that facilitate a stock issuance or recapitalization, the proposed regulations are consistent with existing law, which provides that such capital expenditures do not create a separate intangible asset, but instead offset the proceeds of the stock issuance. See Rev. Rul. 69–330, 1969–1 C.B. 51; Affiliated Capital Corp. v. Commissioner, 88 T.C. 1157 (1987). The proposed regulations provide that capitalization is not required under this provision for stock issuance costs of open-end regulated investment companies (other than those costs incurred during the initial stock offering period). See Rev. Rul. 94–70, 1994–2 C.B. 17.

As discussed in Part VII of this preamble, costs required to be capitalized under the second prong of the transaction cost rule are not eligible for the safe harbor amortization provision provided in the regulations. However, comments are requested on whether the safe harbor amortization provision should apply to any of these costs.

The term reorganization as used in the second prong of the transaction cost rule contemplates a reorganization in the broad sense of a change to an entity’s capital structure, and not merely a transaction that constitutes a tax-free reorganization under the Code. The terms reorganization and restructuring are broad enough to include transactions under section 351 of the Code, as well as bankruptcy reorganizations. While the term is broad enough to encompass stock redemptions, the treatment of costs incurred in connection with a stock redemption is specifically prescribed by section 162(k). The terms reorganization and restructuring are not intended to refer to mere changes in an entity’s business processes, commonly referred to as “re-engineering.” Thus, a taxpayer’s change from a batch inventory processing system to a “just-in-time” inventory processing system, regardless of whether the taxpayer refers to such change as a business “restructuring,” is not within the scope of the rule, as demonstrated by example in the proposed regulations.

Consistent with existing law, the rule requires capitalization of costs to facilitate a divisive transaction. See Bilar Tool & Die Corp. v. Commissioner, 530 F.2d 708 (6th Cir. 1976). However, the rule does not require capitalization of amounts paid to facilitate a divisive transaction where the divestiture is pursuant to a government mandate, unless the divestiture is a condition of permitting the taxpayer to participate in a separate restructuring or reorganization transaction. See, e.g., El Paso Co. v. United States, 694 F.2d 703 (Fed Cir. 1982); American Stores Co. v. Commissioner, 114 T.C. 458 (2000).

In the ANPRM, the second prong of the transaction cost rule applied to “an appli-
cable asset acquisition within the meaning of section 1060(c).” This language caused confusion as to whether the second prong of the transaction cost rule applied to acquisitions of tangible assets. To clarify that the transaction cost rules do not apply to acquisitions of tangible assets, the proposed regulations delete the reference to section 1060(c). To the extent that tangible assets are acquired in an applicable asset acquisition under section 1060(c), the first prong of the transaction cost rule requires capitalization of transaction costs that facilitate the acquisition of those intangible assets. Transaction costs allocable to tangible assets are capitalized to the extent provided by existing law. The IRS and Treasury Department are considering separate guidance to address the treatment of expenditures to acquire, create, or enhance tangible assets.

B. Facilitate

The proposed regulations provide a “facilitate” standard for purposes of determining whether transaction costs must be capitalized. The facilitate standard is intended to be narrower in scope than a “but-for” standard. Thus, some transaction costs that arguably are capital under a but-for standard, such as costs to downsize a workforce after a corporate merger (including severance payments) or costs to integrate the operations of merged businesses, are not required to be capitalized under a facilitate standard. While such costs may not have been incurred but-for the merger, the costs do not facilitate the merger itself. The proposed regulations provide that an amount facilitates a transaction if it is incurred in the process of pursuing the acquisition, creation, or enhancement of an intangible asset or in the process of pursuing a restructuring, reorganization, or transaction involving the acquisition of capital.

In response to the ANPRM, commentators suggested that the proposed regulations should distinguish costs to facilitate the acquisition of a trade or business from costs to investigate the acquisition of a trade or business. Several commentators suggested that the proposed regulations should adopt the standard contained in Rev. Rul. 99–23, 1999–1 C.B. 998.

Rev. Rul. 99–23 provides a “whether-and-which” test for distinguishing costs to investigate the acquisition of a new trade or business (which are amortizable under section 195) from costs to facilitate the acquisition (which are capital expenditures under section 263(a) and are not amortizable under section 195). Under this test, costs incurred to determine whether to acquire a new trade or business, and which new trade or business to acquire, are investigatory costs. Costs incurred in the attempt to acquire a specific business are costs to facilitate the consummation of the acquisition.

Because Rev. Rul. 99–23 has created controversy between taxpayers and the IRS, the proposed regulations do not adopt the standard contained in Rev. Rul. 99–23. Rather, the proposed regulations provide, as a bright line rule, that an amount paid in the process of pursuing an acquisition of a trade or business (whether the acquisition is structured as an acquisition of stock or of assets and whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) is required to be capitalized only if the amount is “inherently facilitative” or if the amount relates to activities performed after the earlier of the date a letter of intent (or similar communication) is issued or the date the taxpayer’s Board of Directors approves the acquisition proposal. For this purpose, the proposed regulations identify amounts that are inherently facilitative (e.g., amounts relating to determining the value of the target, drafting transactional documents, or conveying property between the parties). Under this bright line rule, an amount that does not facilitate the acquisition is not required to be capitalized under this section. The proposed regulations do not affect the treatment of start-up expenditures under section 195. The IRS and Treasury Department are considering the application of these bright line standards to tangible assets acquired as part of a trade or business in order to provide a single administrable standard in these transactions. The IRS and Treasury Department request comments on whether the bright line standard provided in the proposed regulations is administrable and whether there are other bright line standards that can be applied in this area.

The proposed regulations provide that a success-based fee is an amount paid to facilitate the acquisition except to the extent that evidence clearly demonstrates that some portion of the amount is allocable to activities that do not facilitate the acquisition. The IRS and Treasury Department request comments on the treatment of success-based fees.

The IRS and Treasury Department stress that section 6001 of the Code requires taxpayers to maintain sufficient records to support a position claimed on the taxpayer’s return. Thus, taxpayers must maintain records adequate to document that amounts relate to activities performed prior to the bright line date. Comments are requested on the types of records that are available in the context of an acquisition of a trade or business and how these records might be utilized to administer the bright line rule.

C. Hostile takeover defense costs

The proposed regulations provide that transaction costs incurred by a taxpayer to defend against a hostile takeover of the taxpayer’s stock do not facilitate the acquisition and therefore are not required to be capitalized. See A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482 (7th Cir. 1997).

The proposed regulations recognize, however, that an initially hostile acquisition attempt may eventually become friendly. In such a case, the rules require the taxpayer to bifurcate its costs between those incurred to defend against the acquisition attempt at the time the attempt was hostile and those incurred to facilitate the friendly acquisition. Capitalization is required for costs incurred to facilitate the friendly acquisition. The IRS and Treasury Department request comments on rules that might be applied to determine the point at which a hostile acquisition attempt becomes friendly.

Some costs may be viewed both as costs to defend against a hostile acquisition and as costs to facilitate another capital transaction. For example, a taxpayer may attempt to thwart a hostile acquisition by merging with a white knight, recapitalizing, or issuing stock purchase rights to existing shareholders. The proposed regulations require capitalization of such costs, regardless of whether the taxpayer’s purpose in incurring such costs was solely to defend against a hostile acquisition.
D. Simplifying conventions applicable to transaction costs

1. Salaries and Overhead

Much of the recent debate surrounding section 263(a) has focused on the extent to which capitalization is required for employee compensation and overhead costs that are related to the acquisition, creation, or enhancement of an asset. Generally, courts and the Service have required capitalization of such costs where the facts show that the costs clearly are allocable to a particular asset. See Commissioner v. Idaho Power Co., 418 U.S. 1 (1973) (requiring capitalization of depreciation on equipment used to construct capital assets and noting that salaries, when paid in connection with the construction or acquisition of a capital asset, must be capitalized and amortized over the life of the capital asset); Louisville and N.R. Co. v. Commissioner, 641 F.2d 435 (6th Cir. 1981) (requiring capitalization of overhead costs associated with building and rebuilding railroad freight cars); Lychak v. Commissioner, 116 T.C. 374 (2001) (requiring capitalization of employee compensation where employees spent a significant portion of their time working on acquisitions of installment obligations); Rev. Rul. 73–580, 1973–2 C.B. 86 (requiring capitalization of employee compensation reasonably attributable to services performed in connection with corporate mergers and acquisitions).

In the context of intangible assets, some courts have allowed taxpayers to deduct employee compensation and overhead where there is only an indirect nexus between the intangible asset and the compensation or overhead. See Wells Fargo v. Commissioner, 224 F.3d 874 (8th Cir. 2000) (deduction allowed for officer’s salaries allocable to work performed by corporate officers in negotiating a merger transaction because the salaries “originated from the employment relationship between the taxpayer and its officers” and not from the merger transaction); PNC Bancorp v. Commissioner, 212 F.3d 822 (3rd Cir. 2000) (deduction allowed for compensation and other costs of originating loans to borrowers); Lychak v. Commissioner, 116 T.C. 374 (2001) (capitalization not required for overhead costs allocable to the taxpayer’s acquisition of installment loans because the overhead did not originate in the process of acquiring the installment notes, and would have been incurred even if the taxpayer did not engage in such acquisition).

To resolve much of this controversy, and to eliminate the burden on taxpayers of allocating certain transaction costs among various intangible assets, the proposed regulations provide a simplifying assumption that employee compensation and overhead costs do not facilitate the acquisition, creation or enhancement of an intangible asset. The rule applies regardless of the percentage of the employee’s time that is allocable to capital transactions. For example, compensation and overhead costs allocable to work performed by corporate officers in negotiating a merger transaction are not required to be capitalized where the transaction does not exceed $5,000. The IRS and Treasury Department anticipated that any such book-tax conformity rule would not apply to de minimis costs.

The proposed regulations do not presently include a book-tax conformity rule. However, the IRS and Treasury Department request comments on whether the final regulations should apply a book-tax conformity rule to employee compensation and overhead.

2. De Minimis Costs

The proposed regulations provide that de minimis transaction costs do not facilitate a capital transaction and therefore are not required to be capitalized. The rule defines de minimis costs as costs that do not exceed $5,000. The IRS and Treasury Department considered whether the de minimis rule should be based on the taxpayer’s gross receipts, total assets, or some other variable benchmark, rather than a fixed amount. The IRS and Treasury Department decided not to adopt such an approach because of concern that it would add complexity and create administrability issues, particularly where the benchmark amount changes as a result of amended returns or audit adjustments.

The proposed regulations clarify that the de minimis rule applies on a transaction-by-transaction basis. As demonstrated by examples in the proposed regulations, a single transaction may involve the acquisition of multiple intangible assets. The proposed regulations also clarify that if transaction costs (other than compensation and overhead) exceed $5,000, no portion of the costs is considered de minimis under the rule. Thus, all of the costs (not just the cost in excess of $5,000) must be capitalized. The IRS and Treasury Department request comments on whether additional rules are required to prevent taxpayers from improperly fragmenting agreements or transactions to take advantage of the de minimis rules contained in the proposed regulations.

The proposed regulations contain rules for aggregating costs allocable to a transaction. While taxpayers generally must account for the actual costs allocable to each transaction, the proposed regulations permit taxpayers to determine the applicability of the de minimis rules by computing the average transaction cost for a pool of similar transactions. The IRS and Treasury Department recognize that this average cost pooling method could result in a
skewed average cost where several unusually large transactions occur during the year and request comments on how to address such transactions. If the final regulations ultimately provide this pooling mechanism for computing average transaction costs, taxpayers are reminded of their obligations under section 6001 of the Code to maintain such records as are sufficient to establish the amount of any deductions claimed as de minimis costs.

The proposed regulations provide that the de minimis rule does not apply to commissions paid to acquire or create certain financial interests. Accordingly, taxpayers must capitalize such commissions. The IRS and Treasury Department note that the treatment of commissions is well-settled under existing law. See Helvering v. Winnmill, 305 U.S. 79 (1938); § 1.263(a)–2(e). In addition, because commissions generally are traceable to a particular acquisition or creation, no simplification is gained by treating commissions as de minimis costs.

3. Regular and Recurring Costs

The ANPRM requested public comment on whether the recurring or nonrecurring nature of a transaction is an appropriate consideration in determining whether an expenditure incurred to facilitate a transaction must be capitalized under section 263(a) and, if so, what criteria should be applied in distinguishing between recurring and nonrecurring transactions. The IRS and Treasury Department considered the public comments and concluded that a regular and recurring rule would likely be too vague to be administrable. The IRS and Treasury Department believe that the simplifying conventions for employee compensation, overhead, and de minimis costs address the types of regular and recurring costs that are most appropriately excluded from capitalization. Thus, a regular and recurring rule is not provided in the proposed regulations.

VI. 12-Month Rule

A. In general

The existing regulations under sections 263(a), 446, and 461 require taxpayers to capitalize expenditures that create an asset having a useful life substantially beyond the close of the taxable year. See §§ 1.263(a)–2(a), 1.446–1(c)(1)(ii), and 1.461–1(a)(2)(i). In determining whether an asset has a useful life substantially beyond the close of the taxable year, some courts have adopted a “one-year” rule. U.S. Freightways Corp. v. Commissioner, 270 F.3d 1137 (7th Cir. 2001), rev’d 113 T.C. 329 (1999); Zaminovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980). Under this rule, an expenditure may be deducted in the year it is incurred, as long as the benefit resulting from the expenditure does not have a useful life that extends beyond one year.

The IRS and Treasury Department think that a “12-month” rule would help to reduce the administrative and compliance costs inherent in applying section 263(a) to amounts paid to create or enhance intangible assets. Accordingly, under the proposed regulations, certain amounts (including transaction costs) paid to create or enhance intangible rights or benefits for the taxpayer that do not extend beyond the period prescribed by the 12-month rule are treated as having a useful life that does not extend substantially beyond the close of the taxable year. Thus, such amounts are not required to be capitalized under the proposed regulations.

The 12-month rule does not apply to amounts paid to create or enhance financial interests or to amounts paid to create or enhance self-created amortizable section 197 intangibles (as described in section 197(c)(2)(A)). Application of the 12-month rule to self-created amortizable section 197 intangibles, but not to amortizable section 197 intangibles acquired from another person, would result in inconsistent treatment of amortizable section 197 intangibles. The IRS and Treasury Department are reluctant to treat acquired amortizable section 197 intangibles different from self-created amortizable section 197 intangibles.

The proposed regulations clarify that, for purposes of applying the 12-month rule, an amount paid to terminate a contract described in Part IV.F. of this preamble prior to its expiration date creates a benefit for the taxpayer equal to the unexpired term of the agreement as of the date of termination. Thus, for example, if a lessor incurs costs to terminate a lease with an unexpired term of 10 months, the 12-month rule will apply to those costs.

C. Rights of indefinite duration

The 12-month rule does not apply to contracts or other rights that have an indefinite duration. Rights of indefinite duration include rights that have no period of duration fixed by agreement or law or that are not based on a period of time, but are based on a right to provide or receive a fixed amount of goods or services. The IRS and Treasury Department believe that, in many cases, application of the 12-month rule to contracts or other rights that are not based on a period of time would necessitate speculation regarding whether the contract or other right could reasonably be expected to be completed within 12 months. In addition, the IRS and Treasury Depart-
The IRS and Treasury Department are considering rules that permit taxpayers who create, renew, or enhance a certain minimum number of similar rights or benefits during a taxable year to pool those transactions for purposes of applying the 12-month rule. The proposed regulations provide a broad outline of one pooling method under consideration by the IRS and Treasury Department. This method allows taxpayers to apply the reasonable expectancy of renewal test to pools of similar rights or benefits. Under this proposed method, taxpayers are required to capitalize an expenditure to obtain a right or benefit by reference to the reasonable expectancy of renewal for the pool. The proposed regulations provide that, if less than 20 percent of the rights or benefits in the pool are reasonably expected to be renewed, the taxpayer need not capitalize any costs for the rights or benefits in the pool. On the other hand, if more than 80 percent of the rights or benefits in the pool are reasonably expected to be renewed, the taxpayer must capitalize all costs (other than de minimis costs described in Parts IV.E. and V.D.2. of this preamble) for the rights or benefits in the pool. If 20 percent or more but 80 percent or less of the rights or benefits in the pool are reasonably expected to be renewed, the taxpayer must capitalize a percentage of costs corresponding to the percentage of rights or benefits in the pool that are reasonably expected to be renewed. The proposed regulations provide that taxpayers may define a pool of similar contracts for this purpose using any reasonable method. A reasonable method would include a definition of a pool based on the type of customer and the type of property or service provided.

The IRS and Treasury Department stress that the pooling methods outlined in these proposed regulations are not effective unless these pooling methods are ultimately promulgated in final regulations. Accordingly, these proposed regulations do not provide authority for taxpayers to adopt the pooling methods outlined herein. Public comments are requested regarding the following specific issues related to pooling (both with respect to pools established for purposes of applying the 12-month rule and with respect to pools established for purposes of applying the de minimis rules):

(a) Would pooling be a useful simplification measure for taxpayers?

(b) Should a pooling method be provided in final regulations, or are rules governing pooling more appropriately issued in the form of industry-specific guidance or other non-regulatory guidance (e.g., revenue procedure)?

(c) Should a pooling method be treated as a method of accounting under section 446?

(d) Should the regulations define what constitutes “similar” contract rights or other rights for purposes of defining a pool? If so, what factors should be considered in determining whether rights are similar?

(e) Should the regulations require the use of the same pools for depreciation purposes as are used for purposes of determining the amount capitalized under the regulations? Is additional guidance necessary to clarify the interaction of the pooling rules with the rules in section 167 and §1.167(a)–8?

(f) The IRS and Treasury Department intend to require a minimum number of similar transactions that a taxpayer must engage in during a taxable year in order to be eligible to apply the pooling method. Comments are requested regarding what this minimum number of similar transactions should be.

VII. Safe Harbor Amortization

A. In general

The proposed regulations amend §1.167(a)–3 to provide a 15-year safe harbor amortization period for certain created or enhanced intangibles that do not have readily ascertainable useful lives. For example, amounts paid to obtain certain memberships or privileges of indefinite duration would be eligible for the safe harbor amortization provision. Under the safe harbor, amortization is determined using a straight-line method with no salvage value.

The prescribed 15-year period is consistent with the amortization period prescribed by section 197. Many commentators suggested that any safe harbor amortization period should be no longer than 60 months, and noted that a 60-month amortization period is consistent with amortization periods prescribed by sections 195 (start-up expenditures), 248 (organizational expenditures), and 709 (partnership organization and syndication fees) of the Code. The IRS and Treasury Department are concerned that an amortization period shorter than 15 years would create tension with sec-
tion 197, and might encourage attempts to circumvent the provisions of section 197. The safe harbor amortization period does not apply to intangibles acquired from another party or to created financial interests. These intangibles are generally not amortizable, are amortizable under section 197, or are amortizable over a period prescribed by other provisions of the Code or regulations.

The safe harbor amortization period also does not apply to created intangibles that have readily ascertainable useful lives on which amortization can be based. Existing law permits taxpayers to amortize intangible assets with reasonably estimable useful lives. § 1.167(a)–3. For instance, prepaid expenses, contracts with a fixed duration, and certain contract terminations have readily ascertainable useful lives on which amortization can be based. Prepaid expenses are amortized over the period covered by the prepayment. Amounts paid to induce another to enter into a contract with a fixed duration are amortized over the duration of the contract. Amounts paid by a lessor to terminate a lease contract are amortized over the remaining term of the lease. Peerless Weighing and Vending Machine Corp. v. Commissioner, 52 T.C. 850, 852 (1969).

The safe harbor amortization period does not overrule existing amortization periods prescribed or prohibited by the Code, regulations, or other guidance. See, e.g., section 167(f)(1)(A) (prescribing a 36-month life for certain computer software); 171 (prescribing rules for determining the amortization period for bond premium); 178 (prescribing the amortization period for costs to acquire a lease); 197 (prescribing a 15-year life for certain intangible assets); § 1.167(a)–14(d)(1) (prescribing a 108-month useful life for mortgage servicing rights).

Finally, the 15-year safe harbor does not apply to amounts paid in connection with real property owned by another. As discussed in Part IV.G. of this preamble, the proposed regulations provide a 25-year safe harbor amortization period for those amounts.

B. Restructurings, reorganizations and transactions involving the acquisition of capital

The proposed regulations do not provide safe harbor amortization for capitalized transaction costs that facilitate a stock issuance or other transaction involving the acquisition of capital. The regulations maintain the historical treatment of stock issuance costs and costs that facilitate a recapitalization. Historically, such costs have been treated as a reduction of capital proceeds from the transaction, and not as a separate intangible asset that is amortizable over a useful life. See Rev. Rul. 69–330, 1969–1 C.B. 51; Affiliated Capital Corp. v. Commissioner, 88 T.C. 1157 (1987).

In addition, the proposed regulations do not allow safe harbor amortization for capitalized transaction costs that facilitate a restructuring or reorganization of a business entity. As discussed below, comments are requested regarding the appropriateness of applying the safe harbor amortization period to certain of these costs.

1. Acquirer’s Costs in a Taxable Acquisition

The safe harbor amortization provisions do not apply to transaction costs properly capitalized by an acquirer to facilitate the acquisition of the stock or assets of a target corporation in a taxable acquisition. In such a case, existing law provides that transaction costs are properly capitalized to the basis of the stock or assets acquired. See Woodward v. Commissioner, 397 U.S. 572 (1970). In the case of a stock acquisition, the capitalized transaction costs are not amortizable, but offset any subsequent gain or loss realized on the disposition of the stock. In the case of an asset acquisition, the capitalized transaction costs generally may be recovered as part of the recovery of the basis of the assets.

2. Target’s Costs in a Taxable Acquisition

The safe harbor amortization rules also do not apply to transaction costs incurred by a target to facilitate the acquisition of its assets by an acquirer in a taxable transaction. In such a case, the transaction costs generally are an offset against any gain or loss realized by the target on the disposition of its assets.

While the proposed regulations do not allow safe harbor amortization of transaction costs capitalized by a target to facilitate the acquisition of its stock by an acquirer in a taxable transaction, the IRS and Treasury Department request comments on whether safe harbor amortization should be allowed in such a transaction. Existing law provides no useful life for these capitalized costs, and little guidance concerning when taxpayers may recover these costs. See, e.g., INDOPOCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992) (indicating that where no specific asset or useful life can be ascertained, a capitalized cost is deducted upon dissolution of the enterprise). The IRS and Treasury Department believe that the application of a safe harbor amortization period to such costs might help to eliminate much of the current controversy that exists concerning the proper treatment of these costs.

3. Acquirer’s and Target’s Costs in a Tax-Free Acquisition

In determining whether the safe harbor amortization provision should apply to transaction costs that facilitate a tax-free acquisition, threshold issues exist regarding the proper treatment of capitalized costs. Comments are requested concerning the following issues:

(a) Should an acquirer’s capitalized transaction costs in a tax-free acquisition of a target be added to the acquirer’s basis in the target’s stock or assets acquired? If so, should amortization of such costs under the safe harbor amortization provision be prohibited on the ground that the capitalized 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)? On the other hand, if the carryover basis rules of section 362(b) of the Code prohibit the acquirer from increasing its basis in the acquired stock or assets by the amount of the capitalized transaction costs, should the capitalized transaction costs be viewed as a separate intangible asset with an indefinite useful life?

(b) Should a target’s capitalized transaction costs in a tax-free acquisition that is treated as a stock acquisition be viewed as a separate intangible asset with an indefinite useful life?

(c) Should a target’s capitalized transaction costs in a tax-free acquisition that is treated as an asset acquisition be viewed as an intangible asset with an indefinite useful life, or are such costs better viewed as...
a reduction of target’s amount realized or as an increase in target’s basis in its assets immediately prior to the acquisition?

(d) If an acquirer’s (or a target’s) capitalized transaction costs are viewed as a separate intangible asset with an indefinite useful life, should amortization be permitted for such costs under the safe harbor amortization provision, or does section 197(e)(8) of the Code evince a Congressional intent to prohibit any amortization of transaction costs capitalized in a tax-free reorganization?

(e) To what extent should the safe harbor amortization provision apply to capitalized transaction costs that facilitate tax-free transactions other than the acquisitive transactions discussed above (e.g., transactions under sections 351 and 355)?

4. Costs to Facilitate a Borrowing

Existing law requires that capitalized transaction costs incurred to borrow money (debt issuance costs) be deducted over the term of the debt. For example, see Enoch v. Commissioner, 57 T.C. 781 (1972). The regulations do not propose to change this treatment. Accordingly, the safe harbor amortization provision does not apply to capitalized debt issuance costs. However, in order to conform the rules for debt issuance costs with the rules for original issue discount, the proposed regulations generally require the use of a constant yield method to determine how much of these costs are deductible each year by the borrower. See proposed § 1.1446–5.

VIII. Computer Software Issues

The ANPRM requested public comments on the rules and principles that should apply in distinguishing acquired software from developed software. Under existing law, costs to acquire software are appropriately capitalized and may be amortized over 36 months or, in some cases, 15 years. Sections 167(f) and 197(d)(1)(C)(iii). Costs to develop software, on the other hand, may be deducted as incurred in accordance with Rev. Proc. 2000–50, 2000–2 C.B. 601.

The determination of whether software is developed or acquired is a factual inquiry that depends on an analysis of the activities performed by the various parties to the software transaction. While a few commentators identified factors that help to distinguish acquired software from developed software, commentators also suggested that this issue should be addressed in separate guidance, and not in the proposed regulations.

The IRS and Treasury Department agree that the determination of whether computer software is acquired or developed raises issues that are beyond the scope of these proposed regulations. Accordingly, the proposed regulations do not provide rules for distinguishing acquired software from developed software. These issues will be addressed in subsequent guidance.

Many commentators suggested that the proposed regulations should provide guidance concerning the treatment of costs to implement acquired software. For example, commentators noted that issues often arise regarding the extent to which section 263(a) requires capitalization of costs to implement Enterprise Resource Planning (ERP) software. ERP software is an enterprise-wide database software system that integrates business functions such as financial accounting, sales and distribution, materials management, and production planning. Implementation of an ERP system may take several years and generally involves various categories of costs, including (1) costs to acquire the ERP software package from the vendor, (2) costs to install the acquired ERP software on the taxpayer’s computer hardware and to configure the software to the taxpayer’s needs through the use of the options and templates embedded in the software, (3) software development costs, and (4) costs to train employees in the use of the new software.

The proposed regulations do not specifically address the treatment of ERP software. However, the IRS and Treasury Department expect that the final regulations will address these costs and, subject to the simplifying conventions provided in the regulations for employee compensation, overhead, and de minimis transaction costs, will treat such costs in a manner consistent with the treatment prescribed in Private Letter Ruling 200236028 (June 4, 2002) (available in the IRS Freedom of Information Act Reading Room, 1111 Constitution Avenue, NW, Washington, DC 20224). The IRS and Treasury Department request comments on the treatment of ERP implementation costs under the principles contained in these proposed regulations.

IX. Proposed Effective Date

These regulations are proposed to be applicable on the date on which the final regulations are published in the Federal Register. The regulations provide rules applicable to taxpayers that seek to change a method of accounting to comply with the rules contained in the final regulations. Taxpayers may not change a method of accounting in reliance upon the rules contained in these proposed regulations until the rules are published as final regulations in the Federal Register.

Upon publication of the final regulations, taxpayers must follow the applicable procedures for obtaining the Commissioner’s automatic consent to a change in accounting method. The proposed regulations provide that any change in a method of accounting is made using an adjustment under section 481(a), but that such adjustment is determined by taking into account only amounts paid or incurred on or after the date the final regulations are published in the Federal Register.

The IRS and Treasury Department are concerned about the potential administrative burden on taxpayers and the IRS that may result from a section 481(a) adjustment that takes into account amounts paid or incurred prior to the effective date of the regulations. Given the potential for section 481(a) adjustments that originate many years prior to the effective date of the regulations, the IRS and Treasury Department question whether adequate documentation is available to compute the adjustment with reasonable accuracy.

The IRS and Treasury Department request comments on whether there are circumstances in which it is appropriate to permit a change in method of accounting to be made using an adjustment under section 481(a) that takes into account amounts paid or incurred prior to the effective date of the regulations. If there are such circumstances, comments are requested on the appropriate number of taxable years prior to the effective date of the regulations that taxpayers should be permitted to look back for purposes of computing the adjustment. Finally, the IRS and Treasury Department request comments on any additional terms and conditions for changes in methods of accounting that would be helpful to taxpayers in adopting the rules contained in these regulations.
Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or oral comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for April 22, 2003, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 1, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Andrew J. Keyso of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART I — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.167(a)–3 is amended by:

1. Adding a paragraph designation and heading to the undesignated paragraph.

2. Adding paragraph (b).

The additions read as follows:

§ 1.167(a)–3 Intangibles.

(a) In general. * * *

(b) Safe harbor amortization for certain intangible assets — (1) Amortization period. For purposes of determining the depreciation allowance referred to in paragraph (a) of this section, a taxpayer may treat an intangible asset as having a useful life equal to 15 years unless —

(i) An amortization period for the intangible asset is specifically prescribed or prohibited by the Internal Revenue Code, regulations, or other published guidance;

(ii) The intangible asset is described in § 1.263(a)–4(c) (relating to intangibles acquired from another person) or § 1.263(a)–4(d)(2) (relating to created financial interests);

(iii) The intangible asset has a useful life that is readily ascertainable; or

(iv) The intangible asset is described in § 1.263(a)–4(d)(8) (relating to certain benefits arising from the provision, production, or improvement of real property), in which case the taxpayer may treat the intangible asset as having a useful life equal to 25 years.
(i) An amount paid to acquire, create, or enhance an intangible asset (within the meaning of paragraph (b)(2) of this section);

(ii) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) the acquisition, creation, or enhancement of an intangible asset; and

(iii) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.

(2) Intangible asset — (i) In general. For purposes of this section, the term intangible asset means —

(A) An intangible described in paragraph (c) of this section (relating to acquired intangibles);

(B) An intangible described in paragraph (d) of this section (relating to certain created or enhanced intangibles);

(C) A separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section; or

(D) A future benefit identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as an intangible asset for which capitalization is required under this section.

(ii) Published guidance. Any published guidance identifying a future benefit as an intangible asset for which capitalization is required under paragraph (b)(2)(i)(D) of this section applies only to amounts paid on or after the date of publication of the guidance.

(3) Separate and distinct intangible asset — (i) Definition. The term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money’s worth that is subject to protection under applicable state or federal law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability). The determination of whether an amount is paid to acquire, create, or enhance a separate and distinct intangible asset is made as of the taxable year during which the payment is made.

(ii) Creation or termination of contract rights. Amounts paid to another party to create or originate an agreement with that party that produces rights or benefits for the taxpayer do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). Further, amounts paid to another party to terminate an agreement with that party do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). See paragraphs (d)(2), (6) and (7) of this section for rules that specifically require capitalization of amounts paid to create or terminate certain agreements. See paragraph (e)(1)(ii) of this section for rules relating to the treatment of certain termination payments that facilitate another transaction for which capitalization is required under this section.

(c) Acquired intangibles — (1) In general. A taxpayer must capitalize amounts paid to another party to acquire an intangible from that party in a purchase or similar transaction. Intangibles within the scope of this paragraph (c) include, but are not limited to, the following (if acquired from another party in a purchase or similar transaction):

(i) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other similar entity.

(ii) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes.

(iii) A financial instrument, including, but not limited to —

(A) A letter of credit;

(B) A credit card agreement;

(C) A notional principal contract;

(D) A foreign currency contract;

(E) A futures contract;

(F) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property));

(G) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property)); and

(H) Any other financial derivative.

(iv) An endowment contract, annuity contract, or insurance contract that has or may have cash value.

(v) Non-functional currency.

(vi) A lease contract.

(vii) A patent or copyright.

(viii) A franchise, trademark or tradename (as defined in § 1.197–2(b)(10)).

(ix) An assembled workforce (as defined in § 1.197–2(b)(3)).

(x) Goodwill (as defined in § 1.197–2(b)(1)) or going concern value (as defined in § 1.197–2(b)(2)).

(xi) A customer list.

(xii) A servicing right (for example, a mortgage servicing right).

(xiii) A customer-based intangible (as defined in § 1.197–2(b)(6)) or supplier-based intangible (as defined in § 1.197–2(b)(7)).

(xiv) Computer software.

(2) Readily available software. An amount paid to obtain a nonexclusive license for software that is (or has been) readily available to the general public on similar terms and has not been substantially modified (within the meaning of § 1.197–2(c)(4)) is treated for purposes of this paragraph (c) as an amount paid to another party to acquire an intangible from that party in a purchase or similar transaction.

(3) Intangibles acquired from an employee. Amounts paid to an employee to acquire an intangible from that employee are not required to be capitalized under this section if the amounts are treated as compensation for personal services includible in the employee’s income under section 61 or 83. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(4) Examples. The following examples illustrate the rules of this paragraph (c):

Example 1. Financial instrument. X corporation, a commercial bank, purchases a portfolio of existing loans from Y corporation, another financial institution. X pays Y $2,000,000 in exchange for the portfolio. The $2,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation holds a call option entitling it to purchase from W all of the outstanding stock of X at a certain price per share. Z corporation acquires the call option from Y in exchange for $5,000,000. The $5,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 3. Ownership interest in a corporation. Same as Example 2, but assume Z exercises its option and purchases from W all of the outstanding stock of X in exchange for $100,000,000. The $100,000,000 paid to W constitutes an amount paid to acquire an intangible from W and must be capitalized.

Example 4. Customer list. N corporation, a retailer, sells its products exclusively through its catalog and mail order system. N purchases a customer
list from R corporation. N pays R $100,000 in exchange for the customer list. The $100,000 paid to R constitutes an amount paid to acquire an intangible from R and must be capitalized.

Example 3. Lease. V corporation seeks to lease commercial property in a prominent downtown location of city R. V identifies desirable property in city R that is currently under lease by X corporation to W corporation under a 10-year assignable lease. V pays W $50,000 to acquire the lease and relocates its operations from city O to city R. The $50,000 paid to W constitutes an amount paid to W to acquire an intangible from W and must be capitalized.

Example 6. Goodwill. Z corporation pays W corporation $10,000,000 to purchase all of the assets of W in a transaction that constitutes an applicable asset acquisition under section 1060(c). Of the $10,000,000 consideration paid in the transaction, $9,000,000 is allocable to tangible assets purchased from W and $1,000,000 is allocable to goodwill. The $1,000,000 allocable to goodwill constitutes an amount paid to W to acquire intangibles from W and must be capitalized.

(d) Created intangibles — (1) In general. Except as provided in paragraph (f) of this section (relating to the 12-month rule), a taxpayer must capitalize amounts paid to create or enhance an intangible described in this paragraph (d).

(2) Financial interests — (i) In general. A taxpayer must capitalize amounts paid to another party to create or originate with that party any of the following financial interests, whether or not the interest is regularly traded on an established market:

(A) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other similar entity.

(B) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes.

(C) A financial instrument, including, but not limited to —

(1) A letter of credit;

(2) A credit card agreement;

(3) A notional principal contract;

(4) A foreign currency contract;

(5) A futures contract;

(6) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide property or to acquire property (or to be compensated for such property));

(7) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property)); and

(8) Any other financial derivative.

(D) An endowment contract, annuity contract, or insurance contract that has or may have cash value.

(E) Non-functional currency.

(ii) Exception for current and prior sales. An amount is not required to be capitalized under paragraph (d)(2)(i)(C)(6) or (7) of this section if the amount is allocable to property required to be provided or acquired by the taxpayer prior to the end of the taxable year in which the amount is paid.

(iii) Coordination with other provisions of this paragraph (d). An amount described in this paragraph (d)(2) that is also described elsewhere in paragraph (d) of this section is treated as described only in this paragraph (d)(2).

(iv) Examples. The following examples illustrate the rules of this paragraph (d)(2):

Example 1. Loan. X corporation, a commercial bank, makes a loan to A in the principal amount of $250,000. Under paragraph (d)(2)(i)(B) of this section, the $250,000 principal amount of the loan paid to A constitutes an amount paid to another party to create a financial instrument with that party and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation pays W $1,000,000 in exchange for W’s grant of a 3-year call option to Y permitting Y to purchase all of the outstanding stock of X at a certain price per share. Under paragraph (d)(2)(i)(C)(7) of this section, Y’s payment of $1,000,000 to W constitutes an amount paid to another party to create or originate an option with that party and must be capitalized.

Example 3. Partnership interest. Z corporation pays $10,000 to P, a partnership, in exchange for an ownership interest in P. Under paragraph (d)(2)(i)(A) of this section, Z’s payment of $10,000 to P constitutes an amount paid to another party to create an ownership interest in a partnership with that party and must be capitalized.

Example 4. Take or pay contract. Q corporation, a producer of natural gas, pays $1,000,000 to R during 2002 to induce R corporation to enter into a 5-year “take or pay” gas purchase contract. Under the contract, R is liable to pay for a specified minimum amount of gas, whether or not R takes such gas. Under paragraph (d)(2)(i)(C)(6) of this section, Q’s payment is an amount paid to another party to induce that party to enter into an agreement providing Q the right and obligation to provide property or be compensated for such property, regardless of whether the property is provided. Because the agreement does not require that the property be provided prior to the end of the taxable year in which the amount is paid, Q must capitalize the entire $1,000,000 paid to R.

Example 5. Agreement to provide property. P corporation pays R corporation $1,000,000 in exchange for R’s agreement to purchase 1,000 units of P’s product at any time within the three succeeding calendar years. The agreement describes P’s $1,000,000 as a sales discount. Under paragraph (d)(2)(i)(C)(6) of this section, P’s $1,000,000 payment is an amount paid to induce R to enter into an agreement providing P the right and obligation to provide property. Because the agreement does not require that the property be provided prior to the end of the taxable year in which the amount is paid, P must capitalize the entire $1,000,000 payment.

Example 6. Customer incentive payment. S corporation, a computer manufacturer, seeks to develop a business relationship with V corporation, a computer retailer. As an incentive to encourage V to purchase computers from S, S enters into an agreement with V under which S agrees that, if V purchases $20,000,000 of computers from S within 3 years from the date of the agreement, S will pay V $2,000,000 on the date that V reaches the $20,000,000 threshold. V reaches the $20,000,000 threshold during the third year of the agreement, and S pays V $2,000,000. S is not required to capitalize its payment to V under this paragraph (d)(2) because the payment does not provide S the right to provide property. Moreover, the agreement between S and V requires that the computers be provided prior to the end of the taxable year in which the $2,000,000 is paid. In addition, as provided in paragraph (b)(3)(iii) of this section, S’s $2,000,000 payment does not create or enhance a separate and distinct intangible asset for S within the meaning of paragraph (b)(3)(i) of this section.

Example 7. Sales discount. P corporation, a sofa manufacturer that uses the calendar year for federal income tax purposes, seeks to develop a business relationship with R corporation, a furniture retailer. In 2002, P enters into a 5-year agreement with R under which P agrees to reimburse 10 percent of the purchase price paid by R if R purchases more than 1,000 sofas in a single order. In addition, under the agreement, R agrees to purchase 2,000 sofas from P in a single order for delivery during 2002. At the time the agreement is executed, P pays R $20,000, reflecting the 10 percent discount on the first 2,000 sofas to be purchased by R during 2002. The $20,000 payment provides P the right and obligation to provide property (2,000 sofas). Nevertheless, because the agreement requires that the sofas be provided prior to the end of the taxable year in which the amount is paid, P is not required to capitalize its $20,000 payment under this paragraph (d)(2). In addition, as provided in paragraph (b)(3)(ii) of this section, P’s $20,000 payment does not create or enhance a separate and distinct intangible asset for P within the meaning of paragraph (b)(3)(i) of this section.

(3) Prepaid expenses — (i) In general. A taxpayer must capitalize amounts prepaid for benefits to be received in the future.

(ii) Examples. The following examples illustrate the rules of this paragraph (d)(3):

Example 1. Prepaid insurance. N corporation, an accrual method taxpayer, pays $10,000 to an insurer to obtain an insurance policy with a 3-year term. The $10,000 is an amount prepaid by N for benefits to be received in the future and must be capitalized under this paragraph (d)(3).

Example 2. Prepaid rent. X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, X preprocesses $240,000. No other amounts are due under the lease. The $240,000 is an amount prepaid by X for benefits to be received in the future and must be capitalized under this paragraph (d)(3).
(4) Certain memberships and privileges — (i) In general. A taxpayer must capitalize amounts paid to an organization to obtain or renew a membership or privilege from that organization. A taxpayer is not required to capitalize under this paragraph (d)(4) an amount paid to obtain certification of the taxpayer’s products, services, or business processes.

(ii) Examples. The following examples illustrate the rules of this paragraph (d)(4):

Example 1. Hospital privilege. B, a physician, pays $10,000 to Y corporation to obtain lifetime staff privileges at a hospital operated by Y. B must capitalize the $10,000 payment under this paragraph (d)(4).

Example 2. Initiation fee. X corporation pays a $50,000 initiation fee to obtain membership in a social club. X must capitalize the $50,000 payment under this paragraph (d)(4).

Example 3. Product rating. V corporation, an automobile manufacturer, pays W corporation, a national quality ratings association, $100,000 to conduct a study and provide a rating of the quality and safety of a line of V’s automobiles. V’s payment is an amount paid to obtain a certification of V’s product and is not required to be capitalized under this paragraph (d)(4).

Example 4. Business process certification. Z corporation, a manufacturer, seeks to obtain a certification that its quality control standards meet a series of international standards known as ISO 9000. Z pays $50,000 to an independent registrar to obtain a certification from the registrar that Z’s quality management system conforms to the ISO 9000 standard. Z’s payment is an amount paid to obtain a certification of Z’s business processes and is not required to be capitalized under this paragraph (d)(4).

(5) Certain rights obtained from a governmental agency — (i) In general. A taxpayer must capitalize amounts paid to a governmental agency to obtain or renew a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

(ii) Examples. The following examples illustrate the rules of this paragraph (d)(5):

Example 1. Business license. X corporation pays $15,000 to state Y to obtain a business license that is valid indefinitely. Under this paragraph (d)(5), the amount paid to state Y is an amount paid to a governmental agency for a right granted by that agency. Accordingly, X must capitalize the $15,000 payment.

Example 2. Bar admission. A, an individual, pays $1,000 to an agency of state Z to obtain a license to practice law in state Z that is valid indefinitely. Under this paragraph (d)(5), the amount paid to state Z is an amount paid to a governmental agency for a right granted by that agency. Accordingly, A must capitalize the $1,000 payment.

(6) Certain contract rights — (i) In general. Except as otherwise provided in this paragraph (d)(6), a taxpayer must capitalize amounts paid to another party to induce that party to enter into, renew, or renegotiate —

(A) An agreement providing the taxpayer the right to use tangible or intangible property or the right to be compensated for the use of such property;

(B) An agreement providing the taxpayer the right to provide or to acquire services (or the right to be compensated for such services); or

(C) A covenant not to compete or an agreement having substantially the same effect as a covenant not to compete (except, in the case of an agreement that requires the performance of services, to the extent that the amount represents reasonable compensation for services actually rendered).

(ii) De minimis amounts. A taxpayer is not required to capitalize amounts paid to another party (or parties) to induce that party (or those parties) to enter into, renew, or renegotiate an agreement described in paragraph (d)(6)(i) of this section if the aggregate of all amounts paid to that party (or those parties) with respect to the agreement does not exceed $5,000. If the aggregate of all amounts paid to the other party (or parties) with respect to that agreement exceeds $5,000, then all amounts must be capitalized. In general, a taxpayer must determine whether the rules of this paragraph (d)(6)(ii) apply by accounting for the amounts paid with respect to each agreement. However, a taxpayer may elect to establish one or more pools of agreements for purposes of determining the amounts paid with respect to an agreement. Under this pooling method, the amounts paid with respect to each agreement included in the pool is equal to the average amount paid with respect to all agreements included in the pool. A taxpayer computes the average amount paid with respect to all agreements included in the pool by dividing the sum of all amounts paid with respect to all agreements included in the pool by the number of agreements included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(iii) Exceptions — (A) Current and prior sales. An amount is not required to be capitalized under paragraph (d)(6)(i)(B) of this section if the amount is allocable to services required to be provided or acquired by the taxpayer prior to the end of the taxable year in which the amount is paid.

(B) Lessee construction allowances. Paragraph (d)(6)(i) of this section does not apply to amounts paid by a lessor to a lessee as a construction allowance for tangible property (see, for example, section 110).

(iv) Examples. The following examples illustrate the rules of this paragraph (d)(6):

Example 1. New lease agreement. V seeks to lease commercial property in a prominent downtown location of city R. V pays the owner of the commercial property $50,000 as an inducement to enter into a 10-year lease with V. V’s payment is an amount paid to another party to induce that party to enter into an agreement providing V the right to use tangible property. Because the $50,000 payment exceeds $5,000, no portion of the amount paid to Z is de minimis for purposes of paragraph (d)(6)(ii) of this section. Under paragraph (d)(6)(i)(A) of this section, V must capitalize the entire $50,000 payment.

Example 2. Modification of lease agreement. Partnership Y leases a piece of equipment for use in its business from Z corporation. When the lease has a remaining term of 3 years, Y requests that Z modify the lease by extending the remaining term by 5 years. Y pays $50,000 to Z in exchange for Z’s agreement to modify the existing lease. Y’s payment of $50,000 is an amount paid to induce Z to renegotiate an agreement providing Y the right to use property. Because the $50,000 payment exceeds $5,000, no portion of the amount paid to Z is de minimis for purposes of paragraph (d)(6)(ii) of this section. Under paragraph (d)(6)(i)(A) of this section, Y must capitalize the entire $50,000 payment to induce Z to renegotiate the lease.

Example 3. Covenant not to compete. R corporation enters into an agreement with A, an individual, that prohibits A from competing with R for a period of three years. To encourage A to enter into the agreement, R agrees to pay A $100,000 upon the signing of the agreement. R’s payment is an amount paid to another party to induce that party to enter into a covenant not to compete. Because the $100,000 payment exceeds $5,000, no portion of the amount paid to A is de minimis for purposes of paragraph (d)(6)(ii) of this section. Under paragraph (d)(6)(i)(C) of this section, R must capitalize the entire $100,000 paid to A to induce A to enter into the covenant not to compete.

Example 4. De minimis payments. X corporation is engaged in the business of providing wireless telecommunications services to customers. To induce customer B to enter into a 3-year telecommunications contract, X provides B with a free wireless telephone. X pays $300 to purchase the wireless telephone. X’s provision of a wireless telephone to B is an amount paid to B to induce B to enter into an agreement providing X the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Because the amount of the inducement is $300, the amount of the inducement is de minimis under paragraph (d)(6)(ii) of this section. Accordingly, X is not required to capitalize the amount of the inducement provided to B.

(7) Certain contract terminations — (i) In general. A taxpayer must capitalize amounts paid to another party to terminate —

(A) A lease of real or tangible personal property between the taxpayer (as lessor) and that party (as lessee);
(B) An agreement that grants that party the exclusive right to acquire or use the taxpayer’s property or services or to conduct the taxpayer’s business; or
(C) An agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party.

(ii) Examples. The following examples illustrate the rules of this paragraph (d)(7):

Example 1. Termination of exclusive license agreement. On July 1, 2001, N enters into a license agreement with W corporation under which N grants R the exclusive right to manufacture and distribute goods using N’s design and trademarks for a period of 10 years. On June 30, 2003, N pays R $5,000,000 in exchange for R’s agreement to terminate the exclusive license agreement. N’s payment to terminate its license agreement with R constitutes a payment to terminate an exclusive license to use the taxpayer’s property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, N must capitalize its $5,000,000 payment to R.

Example 2. Termination of exclusive distribution agreement. On March 1, 2001, L, a manufacturer, enters into an agreement with M granting M the right to be the sole distributor of L’s products in state X for 10 years. On July 1, 2004, L pays M $50,000 in exchange for M’s agreement to terminate the distribution agreement. L’s payment to terminate its agreement with M constitutes a payment to terminate an exclusive right to acquire L’s property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, L must capitalize its $50,000 payment to M.

Example 3. Termination of covenant not to compete. On February 1, 2001, Y corporation enters into a covenant not to compete with Z corporation that prohibits Y from competing with Z in city V for a period of 5 years. On January 31, 2003, Y pays Z $1,000,000 in exchange for Z’s agreement to terminate the covenant not to compete. Y’s payment to terminate the covenant not to compete with Z constitutes a payment to terminate an agreement that prohibits Y from competing with Z, as described in paragraph (d)(7)(i)(C) of this section. Accordingly, Y must capitalize its $1,000,000 payment to Z.

Example 4. Termination of exclusive right to acquire property. W corporation owns one-half of the outstanding stock of X corporation. On July 1, 2002, W grants Y corporation a 5-year call option that permits Y to purchase all of W’s stock in X. On June 30, 2004, W pays Y $50,000 to terminate the option. W’s payment to terminate the option with Y constitutes a payment to terminate an exclusive right to acquire W’s property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, W must capitalize its $50,000 payment to Y.

Example 5. Termination of supply contract. During 2000, Q corporation enters into a 10-year agreement with R corporation under which R agrees to fulfill all of Q’s requirements for packaging materials and supplies used by Q in the distribution of Q’s goods. During 2005, Q determines that its contract with R has become unprofitable for Q and seeks to terminate the contract. Q pays R $100,000 to terminate the contract. Q’s payment to terminate the supply contract with R is a payment to terminate an agreement not described in this paragraph (d)(7). Accordingly, Q is not required to capitalize the $100,000 payment to R under this paragraph (d)(7). In addition, provided in paragraph (b)(3)(ii) of this section, Q’s $1,000,000 payment does not create or enhance a separate and distinct intangible asset for Q within the meaning of paragraph (b)(3)(i) of this section.

Example 6. Termination of merger agreement. N corporation enters into an agreement with U corporation under which N and U agree to merge. Prior to the merger, N decides that its business will be more successful if it does not merge with U. N pays U $10,000,000 to terminate the agreement. At the time of the payment, N is not under an agreement to merge with any other entity. N’s payment to terminate the merger agreement with U is a payment to terminate an agreement not described in this paragraph (d)(7). Accordingly, N is not required to capitalize the $10,000,000 payment under this paragraph (d)(7). In addition, as provided in paragraph (b)(3)(ii) of this section, N’s $10,000,000 payment does not create or enhance a separate and distinct intangible asset for N within the meaning of paragraph (b)(3)(i) of this section.

(8) Certain benefits arising from the provision, production, or improvement of real property — (i) In general. A taxpayer must capitalize amounts paid for real property redefined to another, or amounts paid to produce or improve real property owned by another, if the real property can reasonably be expected to produce significant economic benefits for the taxpayer.

(ii) Exclusions. A taxpayer is not required to capitalize an amount under paragraph (d)(8)(i) of this section to the extent the payment —

(A) Is part of a transaction involving the sale of the real property by the taxpayer;
(B) Is part of the sale of services by the taxpayer to produce or improve the real property;
(C) Is a payment by the taxpayer for some other property or service provided to the taxpayer; or
(D) Is a payment by the taxpayer to another party to create an intangible described in paragraph (d)(8)(ii)(C) of this section.

(iii) Real property. For purposes of this paragraph (d)(8), real property includes property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as roads, bridges, tunnels, pavements, wharves and docks, breakwaters and sea walls, elevators, power generation and transmission facilities, and pollution control facilities.

(iv) Impact fees and dedicated improvements. Paragraph (d)(8)(i) of this section does not apply to amounts paid to satisfy one-time charges imposed by a state or local government against new development (or expansion of existing development) to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. In addition, paragraph (d)(8)(i) of this section does not apply to amounts paid for real property or improvements to real property constructed by the taxpayer where the real property or improvements benefit new development or expansion of existing development, are immediately transferred to a state or local government for dedication to the general public use, and are maintained by the state or local government. See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in this paragraph (d)(8)(iv).

(v) Examples. The following examples illustrate the rules of this paragraph (d)(8):

Example 1. Amount paid to produce real property owned by another. W corporation operates a quarry on the east side of a river in city Z and a crusher on the west side of the river. City Z’s existing bridges are of insufficient capacity to be traveled by trucks in transferring stone from W’s quarry to its crusher. As a result, the efficiency of W’s operations is greatly reduced. W contributes $1,000,000 to City Z to defray in part the cost of construction of a publicly owned bridge capable of accommodating W’s trucks. W’s payment to City Z is an amount paid to produce real property (within the meaning of paragraph (d)(8)(iii) of this section) that can reasonably be expected to produce significant economic benefits for W. Under paragraph (d)(8)(i) of this section, W must capitalize the $1,000,000 paid to city Z.

Example 2. Dedicated improvements. X corporation is engaged in the development and sale of residential real estate. In connection with a residential real estate project under construction by X in city Z, X is required by city Z to construct ingress and egress roads to and from its project and immediately transfer the roads to city Z for dedication to general public use. The roads will be maintained by city Z. X pays its subcontractor $100,000 to construct the ingress and egress roads. X’s payment is a dedicated improvement within the meaning of paragraph (d)(8)(iv) of this section. Accordingly, X is not required to capitalize the $100,000 payment under this paragraph (d)(8). See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in paragraph (d)(8)(iv) of this section.

(9) Defense or perfection of title to intangible property — (i) In general. A taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property where that other party challenges the taxpayer’s title to the intangible property.

(ii) Example. The following example illustrates the rules of this paragraph (d)(9):

Example. Defense of title. R corporation claims to own an exclusive patent on a particular technology. U corporation brings a lawsuit against R, claiming that
A taxpayer computes the average transaction costs paid with respect to all transactions included in the pool by the number of transactions included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(4) Special rules applicable to certain trade or business acquisition and reorganization transactions — (A) In general. Except as provided in paragraph (e)(4)(i)(B) of this section, in the case of an acquisition of a trade or business (whether structured as an acquisition of stock or of assets and whether the taxpayer is the acquirer in the acquisition or the target of the acquisition), an amount paid in the process of pursuing the acquisition facilitates the acquisition within the meaning of this paragraph (e) only if the amount relates to activities performed on or after the earlier of —

(i) The date on which the acquirer submits to the target a letter of intent, offer letter, or similar written communication proposing a merger, acquisition, or other business combination; or

(2) The date on which an acquisition proposal is approved by the taxpayer’s Board of Directors (or committee of the Board of Directors) or, in the case of a taxpayer that is not a corporation, the date on which the acquisition proposal is approved by the appropriate governing officials of the taxpayer.

(B) Inherently facilitative amounts. An amount paid in the process of pursuing an acquisition facilitates that acquisition if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined under paragraph (e)(4)(i)(A) of this section. An amount is inherently facilitative if the amount is paid for activities performed in determining the value of the target, negotiating or structuring the transaction, preparing and reviewing transactional documents, preparing and reviewing regulatory filings required by the transaction, obtaining regulatory approval of the transaction, securing advice on the tax consequences of the transaction, securing an opinion as to the fairness of the transaction, obtaining shareholder approval of the transaction, or conveying property between the parties to the transaction.

(C) Success-based fees. An amount paid that is contingent on the successful closing of an acquisition is an amount paid to facilitate the acquisition except to the ex-
tent that evidence clearly demonstrates that some portion of the amount is allocable to activities that do not facilitate the acquisition.

(D) Integration costs. An amount paid to integrate the business operations of the acquirer and the target does not facilitate the acquisition within the meaning of paragraph (e)(1)(i) of this section, regardless of when the integration activities occur.

(ii) Divisive transactions — (A) Stock distributions. An amount paid to facilitate a distribution of stock to the shareholders of a taxpayer is not required to be capitalized under this section if the divestiture is required by law, regulatory mandate, or court order unless the divestiture itself facilitates another transaction referred to in paragraph (e)(1)(i) of this section. For example, where a taxpayer, to comply with a new law requiring the taxpayer to divest itself of a particular trade or business, contributes that trade or business to a new subsidiary and distributes the stock of the subsidiary to the taxpayer’s shareholders, amounts paid to facilitate the distribution do not facilitate a transaction referred to in paragraph (e)(1)(i) of this section and are not required to be capitalized under this section. Conversely, where a taxpayer, to secure regulatory approval for its proposed acquisition of a target corporation, complies with a government mandate to divest itself of a particular trade or business and sells the assets of that trade or business in a taxable sale, amounts paid to facilitate the sale are amounts paid to facilitate the acquisition of the target and must be capitalized under this section.

(iii) Defense against a hostile acquisition attempt — (A) In general. An amount paid to defend against an acquisition of the taxpayer in a hostile acquisition attempt is not an amount paid to facilitate a transaction within the meaning of paragraph (e)(1)(i) of this section. In determining whether an acquisition attempt is hostile, all relevant facts and circumstances are taken into account. The mere fact that the taxpayer receives an unsolicited offer from a potential acquirer, or rejects an initial offer from a potential acquirer, is not determinative of whether an acquisition attempt is hostile. On the other hand, the fact that the taxpayer implements defensive measures in response to the acquisition attempt is evidence that the acquisition attempt is hostile. Once an acquisition attempt ceases to be hostile, an amount paid by the taxpayer in the process of pursuing the acquisition of its stock by the acquirer is an amount paid to facilitate a transaction referred to in paragraph (e)(1)(i) of this section.

(B) Exception for amounts paid to facilitate another capital transaction. An amount paid to defend against an acquisition of the taxpayer in a hostile acquisition attempt does not include a payment that, while intended to thwart a hostile acquisition attempt by an acquirer, itself facilitates another transaction referred to in paragraph (e)(1)(i) of this section. Thus, for example, an amount paid to effect a recapitalization in an effort to defend against a hostile acquisition attempt is not an amount paid to defend against an acquisition of the taxpayer in a hostile acquisition attempt for purposes of paragraph (e)(4)(iii)(A) of this section.

(5) Coordination with paragraph (d) of this section. In the case of an amount paid to facilitate the creation or enhancement of an intangible described in paragraph (d) of this section, the provisions of this paragraph (e) apply regardless of whether a payment described in paragraph (d) is made.

(6) Application to stock issuance costs of open-end regulated investment companies. Amounts paid by an open-end regulated investment company (within the meaning of section 851) to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction referred to in paragraph (e)(1)(i) of this section unless such amounts are paid during the initial stock offering period.

(7) Examples. The following examples illustrate the rules of this paragraph (e):

Example 1. Costs to facilitate. In December 2002, R corporation, a calendar year taxpayer, enters into negotiations with X corporation to lease commercial property from X for a period of 25 years. R pays A, its outside legal counsel, $4,000 in December 2002 for services rendered by A during December in assisting with negotiations with X. In January 2003, R and X finalize the terms of the lease and execute the lease agreement. R pays B, another of its outside legal counsel, $2,000 in January 2003 for services rendered by B during January in drafting the lease agreement. The agreement between R and X is an agreement providing R the right to use property, as described in paragraph (d)(6)(i)(A) of this section. R’s payments to its outside counsel are amounts paid to facilitate the creation of the agreement. As provided in paragraph (e)(3)(ii)(A) of this section, R must aggregate its transaction costs for purposes of determining whether the transaction costs are de minimis. Because R’s aggregate transaction costs exceed $5,000, R’s transaction costs are not de minimis costs within the meaning of paragraph (e)(3)(ii)(A) of this section. Accordingly, R must capitalize the $4,000 paid to A and the $2,000 paid to B under paragraph (b)(1)(ii) of this section.

Example 2. Costs to facilitate. Q corporation pays its outside counsel $20,000 to assist Q in registering its stock with the Securities and Exchange Commission. Q is not a regulated investment company within the meaning of section 851. Q’s payments to its outside counsel are amounts paid to facilitate the issuance of stock. Accordingly, Q must capitalize its $20,000 payment under paragraph (b)(1)(iii) of this section.

Example 3. Costs to facilitate. Partnership X leases its manufacturing equipment from Y corporation under a 10-year lease. During 2002, when the lease has a remaining term of 4 years, X enters into a written agreement with Z corporation, a competitor of Y, under which X agrees to lease its manufacturing equipment from Z, subject to the condition that X first successfully terminates its lease with Y. X pays Y $50,000 in exchange for Y’s agreement to terminate the equipment lease. Because the new lease is expressly conditioned on the termination of the old lease agreement, as provided in paragraph (e)(3)(ii) of this section, X’s payment of $50,000 facilitates the creation of a new lease. Accordingly, X must capitalize the $50,000 termination payment under paragraph (b)(1)(ii) of this section.

Example 4. Costs to facilitate. W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 5 years. W pays its outside counsel $7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. Under para-
Exercised stock options the difference between the option price and the current value of T’s stock in consideration of their agreement to cancel their unexercised options. Under paragraph (e)(3)(i) of this section, T is not required to capitalize the amounts paid to its employees.

Example 13. Corporate acquisition; retainer. Y corporation’s outside counsel charges Y $60,000 for services rendered in facilitating the friendly acquisition of the stock of Y corporation by X corporation. Y has an agreement with its outside counsel under which Y pays an annual retainer of $50,000. Y’s outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y’s outside counsel offsets $50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of $10,000. The $60,000 legal fee is an amount paid to facilitate the reorganization of Y as defined in paragraph (e)(1)(i) of this section. Y must capitalize the full amount of the $60,000 legal fee.

Example 14. Corporate acquisition; antitrust defense costs. On March 1, 2002, V corporation enters into an agreement with X corporation to acquire all of the outstanding stock of X. On April 1, 2002, federal and state regulators file suit against V to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. V enters into a consent agreement with regulators on May 1, 2002, that allows the acquisition to proceed, but requires V to hold separate the business operations of X pending the outcome of the antitrust suit and subjects V to possible divestiture. V acquires title to all of the outstanding stock of X on June 1, 2002. After June 1, 2002, the regulators pursue antitrust litigation against V seeking rescission of the acquisition. V pays $50,000 to its outside counsel for services rendered after June 1, 2002, to defend against the antitrust litigation. V ultimately prevails in the antitrust litigation. V’s costs to defend the antitrust litigation are costs to facilitate its acquisition of the stock of X under paragraph (e)(1)(i) of this section and must be capitalized. Although title to the shares of X passed to V prior to the date V incurred costs to defend the antitrust litigation, the amounts paid by V are paid in the process of pursuing the acquisition of the stock of X because the acquisition was not complete until the antitrust litigation was ultimately resolved. Because the amounts paid to defend the suit are not de minimis costs within the meaning of paragraph (e)(3)(iii)(A) of this section, V must capitalize the full $50,000.

Example 15. Corporate acquisition; hostile defense costs. (i) Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation on January 15, 2002. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential “white knight” acquirer, as well as costs to effect a recapitalization. Y’s efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2002, Y’s Board of Directors decides to abandon Y’s incentive stock option plan. These options granted the employees the right to purchase T stock at a fixed option price. The options did not have a readily ascertainable value (within the meaning of § 1.83–7(b)), and thus no amount was included in the employees’ income when the options were granted. As a condition of the acquisition, T is required to terminate its incentive stock option plan. T therefore agrees to pay its employees who hold un

Exercised stock options the difference between the option price and the current value of T’s stock in consideration of their agreement to cancel their unexercised options. Under paragraph (e)(3)(i) of this section, T is not required to capitalize the amounts paid to its employees.

Example 13. Corporate acquisition; retainer. Y corporation’s outside counsel charges Y $60,000 for services rendered in facilitating the friendly acquisition of the stock of Y corporation by X corporation. Y has an agreement with its outside counsel under which Y pays an annual retainer of $50,000. Y’s outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y’s outside counsel offsets $50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of $10,000. The $60,000 legal fee is an amount paid to facilitate the reorganization of Y as defined in paragraph (e)(1)(i) of this section. Y must capitalize the full amount of the $60,000 legal fee.

Example 14. Corporate acquisition; antitrust defense costs. On March 1, 2002, V corporation enters into an agreement with X corporation to acquire all of the outstanding stock of X. On April 1, 2002, federal and state regulators file suit against V to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. V enters into a consent agreement with regulators on May 1, 2002, that allows the acquisition to proceed, but requires V to hold separate the business operations of X pending the outcome of the antitrust suit and subjects V to possible divestiture. V acquires title to all of the outstanding stock of X on June 1, 2002. After June 1, 2002, the regulators pursue antitrust litigation against V seeking rescission of the acquisition. V pays $50,000 to its outside counsel for services rendered after June 1, 2002, to defend against the antitrust litigation. V ultimately prevails in the antitrust litigation. V’s costs to defend the antitrust litigation are costs to facilitate its acquisition of the stock of X under paragraph (e)(1)(i) of this section and must be capitalized. Although title to the shares of X passed to V prior to the date V incurred costs to defend the antitrust litigation, the amounts paid by V are paid in the process of pursuing the acquisition of the stock of X because the acquisition was not complete until the antitrust litigation was ultimately resolved. Because the amounts paid to defend the suit are not de minimis costs within the meaning of paragraph (e)(3)(iii)(A) of this section, V must capitalize the full $50,000.

Example 15. Corporate acquisition; hostile defense costs. (i) Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation on January 15, 2002. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential “white knight” acquirer, as well as costs to effect a recapitalization. Y’s efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2002, Y’s Board of Directors decides to abandon Y’s incentive stock option plan. These options granted the employees the right to purchase T stock at a fixed option price. The options did not have a readily ascertainable value (within the meaning of § 1.83–7(b)), and thus no amount was included in the employees’ income when the options were granted. As a condition of the acquisition, T is required to terminate its incentive stock option plan. T therefore agrees to pay its employees who hold unexercised stock options the difference between the option price and the current value of T’s stock in consideration of their agreement to cancel their unexercised options. Under paragraph (e)(3)(i) of this section, T is not required to capitalize the amounts paid to its employees.
against the takeover and the investment banking fees paid to search for a white knight acquirer do not facilitate the acquisition of Y by Z. Such amounts are paid to defend against Z’s hostile takeover attempt and are not required to be capitalized under this section.

(iii) Under paragraph (c)(4)(iii)(B) of this section, the amounts paid by Y to effect a recapitalization are not amounts paid to defend against a hostile acquisition attempt. Accordingly, the amounts paid to effect the recapitalization must be capitalized under paragraph (b)(1)(iii) of this section.

(iv) The $1,000,000 paid to the investment bankers after Y abandons its defense against the takeover is an amount paid to facilitate an acquisition of Y and must be capitalized under paragraph (b)(1)(iii) of this section.

Example 16. Corporate acquisition; break up fees. (i) N corporation enters into an agreement with U corporation under which U agrees to purchase all of the outstanding stock of N for $70 per share. The agreement between N and U provides that if the acquisition does not succeed, N will pay U $1,000,000 as a break up fee. Prior to the closing of the acquisition, N enters into an agreement with W under which W agrees to purchase all of the outstanding stock of N for $80 per share on the condition that N terminates its pending acquisition agreement with U. N pays U $1,000,000 to terminate the acquisition agreement and N subsequently is acquired by W. Under paragraph (c)(1)(ii) of this section, the $1,000,000 paid to U is an amount paid to facilitate a transaction described in paragraph (b)(1)(iii) of this section. Accordingly, N must capitalize the $1,000,000 payment.

Example 17. Corporate acquisition; break up fees to white knight. Z corporation launches an unsolicited hostile tender offer of $70 per share for 55 percent of the outstanding shares of T corporation. In an effort to defend against a takeover by Z, T enters into an agreement with W corporation, a “white knight” acquirer, under which W agrees to pay $75 per share for all outstanding shares of T if T agrees to recommend the transaction to its shareholders. The agreement between T and W provides that if the acquisition of T by W does not succeed, T will pay W $1,000,000 as a break up fee. Prior to the acquisition of T by W, Z amends its offer to $85 per share for all of the outstanding shares of T. T’s Board of Directors concludes that Z’s amended offer is preferable and recommends that its shareholders accept Z’s amended offer. Z subsequently acquires all of the outstanding shares of T for $85 per share. In accordance with its agreement with W, T pays W $1,000,000 to terminate the acquisition agreement. The $1,000,000 paid to W does not facilitate Z’s acquisition of the outstanding shares of T. Under paragraph (c)(4)(iii) of this section, T’s payment to W is not made pursuant to an agreement under which the acquisition of the outstanding shares of T by Z is expressly conditioned on the termination of the agreement between T and W.

(f) 12-month rule — (1) In general — (i) Amounts paid to create or enhance an intangible asset. A taxpayer is not required to capitalize amounts paid to create or enhance an intangible asset if the amounts do not create or enhance any right or benefit for the taxpayer that extends beyond the earlier of —

(A) 12 months after the first date on which the taxpayer realizes the right or benefit; or

(B) The end of the taxable year following the taxable year in which the payment is made.

(ii) Transaction costs. A taxpayer is not required to capitalize amounts paid to facilitate the creation or enhancement of an intangible asset if, by reason of paragraph (f)(1)(i) of this section, capitalization would not be required for amounts paid to create or enhance that intangible asset.

(2) Duration of benefit for contract terminations. For purposes of this paragraph (f), amounts paid to terminate a contract or other agreement described in paragraph (d)(7)(i) of this section prior to its expiration date (or amounts paid to facilitate such termination) create a benefit for the taxpayer equal to the unexpired term of the agreement as of the date of the termination.

(3) Inapplicability to created financial interests and self-created amortizable section 197 intangibles. Paragraph (f)(1) of this section does not apply to amounts paid to create or enhance an intangible described in paragraph (d)(7)(i) of this section (relating to amounts paid to create or enhance financial interests) or to amounts paid to create or enhance an intangible asset that constitutes an amortizable section 197 intangible within the meaning of section 197(c).

(4) Inapplicability to rights of indefinite duration. Paragraph (f)(1) of this section does not apply to amounts paid to create or enhance a right of indefinite duration. A right has an indefinite duration if it has no period of duration fixed by agreement or by law, or if it is not based on a period of time, such as a right attributable to an agreement to provide or receive a fixed amount of goods or services. For example, a license granted by a governmental agency that permits the taxpayer to operate a business conveys a right of indefinite duration if the license may be revoked only upon the taxpayer’s violation of the terms of the license.

(5) Rights subject to renewal — (i) In general. For purposes of paragraph (f)(1)(i) of this section, the duration of a right includes any renewal period if, based on all of the facts and circumstances in existence during the taxable year in which the right is created, the facts indicate a reasonable expectancy of renewal.

(ii) Reasonable expectancy of renewal. The following factors are significant in determining whether there exists a reasonable expectancy of renewal:

(A) Renewal history. The fact that similar rights are historically renewed is evidence of a reasonable expectancy of renewal. On the other hand, the fact that similar rights are rarely renewed is evidence of a lack of a reasonable expectancy of renewal. Where the taxpayer has no experience with similar rights, or where the taxpayer holds similar rights only occasionally, this factor is less indicative of a reasonable expectancy of renewal.

(B) Economics of the transaction. The fact that renewal is necessary in order for the taxpayer to earn back its investment in the right is evidence of a reasonable expectancy of renewal. For example, if a taxpayer pays $10,000 to enter into a renewable contract with an initial 9-month term that is expected to generate income to the taxpayer of $1,000 per month, the fact that renewal is necessary in order for the taxpayer to earn back its $10,000 investment is evidence of a reasonable expectancy of renewal.

(C) Likelihood of renewal by other party. Evidence that indicates a likelihood of renewal by the other party to a right, such as a bargain renewal option or similar arrangement, is evidence of a reasonable expectancy of renewal. However, the mere fact that the other party will have the opportunity to renew on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value, is not evidence of a reasonable expectancy of renewal.

(D) Terms of renewal. The fact that material terms of the right are subject to renegotiation at the end of the initial term is evidence of a lack of a reasonable expectancy of renewal. For example, if the parties to an agreement must renegotiate price or amount, the renegotiation requirement is evidence of a lack of a reasonable expectancy of renewal.

(iii) Safe harbor pooling method. In lieu of applying the reasonable expectancy of renewal test described in paragraph (f)(5)(ii)
of this section to each separate right created or enhanced during a taxable year, a taxpayer may establish one or more pools of similar rights for which the initial term does not extend beyond the period described in paragraph (f)(1)(i) of this section and may apply the reasonable expectancy of renewal test to each pool. See paragraph (h) of this section for additional rules relating to pooling. The application of paragraph (f)(1) of this section to each pool is determined in the following manner:

(A) All amounts (except de minimis amounts described in paragraph (d)(6)(ii) of this section) paid to create or enhance the rights included in the pool and all amounts paid to facilitate the creation or enhancement of the rights included in the pool are aggregated.

(B) If less than 20 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section, all rights in the pool are treated as having a duration that does not extend beyond the period prescribed in paragraph (f)(1)(i) of this section, and the taxpayer is not required to capitalize under this section any portion of the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(C) If more than 80 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section, all rights in the pool are treated as having a duration that extends beyond the period prescribed in paragraph (f)(1)(i) of this section, and the taxpayer is required to capitalize under this section the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(D) If 20 percent or more, but 80 percent or less, of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section, the aggregate amount described in paragraph (f)(5)(iii)(A) of this section is multiplied by the percentage of the rights in the pool that are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1)(i) of this section and the taxpayer must capitalize the resulting amount under this section by treating such amount as creating a separate intangible asset.

(6) Rights terminable at will. A right is not described in paragraph (f)(1)(i) of this section merely because the right is terminable at will by either party. However, for purposes of paragraph (f)(5) of this section, the fact that similar rights are typically terminated prior to renewal is relevant in determining whether there exists a reasonable expectancy of renewal for the right.

(7) Coordination with section 461. In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See §1.461–4(d) for rules relating to economic performance.

(8) Examples. The rules of this paragraph (f) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer is a calendar year, accrual method taxpayer:

Example 1. Prepaid expenses. On December 1, 2002, N corporation pays a $10,000 insurance premium to obtain a property insurance policy with a 1-year term that begins on February 1, 2003. The amount paid by N is a prepaid expense described in paragraph (d)(5) of this section. Because the right or benefit attributable to the $10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule provided by this paragraph (f) does not apply. N must capitalize the $10,000 payment.

Example 2. Prepaid expenses. Assume the same facts as in Example 1, except that the policy has a term beginning on December 15, 2002. The 12-month rule of this paragraph (f) applies to the $10,000 payment because the right or benefit attributable to the payment extends beyond more than 12 months beyond December 15, 2002 (the first date the benefit is realized by the taxpayer), nor beyond the taxable year following the year in which the payment is made. Accordingly, N is not required to capitalize the $10,000 payment.

Example 3. Financial interests. On October 1, 2002, X corporation makes a 9-month loan to B in the principal amount of $250,000. The principal amount of the loan paid to B constitutes an amount paid to create or originate a financial interest under paragraph (d)(2)(i)(B) of this section. The 9-month term of the loan does not extend beyond the period prescribed by paragraph (f)(1)(i) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, X must capitalize the $250,000 loan amount.

Example 4. Financial interests. X corporation owns all of the outstanding stock of Z corporation. On December 1, Y corporation, a calendar year taxpayer, pays X $1,000,000 in exchange for X’s grant of a 9-month call option to Y permitting Y to purchase all of the outstanding stock of Z. Y’s payment to X constitutes an amount paid to create or originate an option with X under paragraph (d)(2)(ii)(C)(7) of this section. The 9-month term of the option does not extend beyond the period prescribed by paragraph (f)(1)(i) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, Y must capitalize the $1,000,000 payment.

Example 5. License. (i) On July 1, 2002, R corporation pays $10,000 to state X to obtain a license to operate a business in state X for a period of 5 years. The terms of the license require R to pay state X an annual fee of $500 due on July 1 of each of the succeeding four years. R pays the $500 fee on July 1 of each succeeding year as required by the license.

(ii) R’s payment of $10,000 is an amount paid to a governmental agency for a license granted by that agency to which paragraph (d)(5) of this section applies. Because R’s payment creates rights or benefits for R that extend beyond the end of 2003 (the taxable year following the taxable year in which the payment is made), the rules of this paragraph (f) do not apply to R’s payment. Accordingly, R must capitalize the $10,000 payment.

Example 6. Lease. On December 1, 2002, W corporation, a calendar year taxpayer, enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 9 months, beginning on December 1, 2002. W pays its outside counsel $7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. W’s $7,000 payment to its outside counsel is an amount paid to facilitate W’s creation of an intangible asset as described in paragraph (c)(1)(i) of this section. Under paragraph (f)(1)(ii) of this section, W’s payment to its outside counsel is not required to be capitalized because, by reason of paragraph (f)(1)(i) of this section (relating to the 12-month rule) an amount described in paragraph (d)(6)(i)(A) of this section to create the agreement between W and X would not be required to be capitalized under this section.

Example 7. Certain contract terminations. V corporation owns real property that it has leased to A for a period of 15 years. When the lease has a remaining unexpired term of 5 years, V requests that A agree to terminate the lease, enabling V to use the property in its trade or business. V pays A $100,000 in exchange for A’s agreement to terminate the lease. V’s payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V’s payment creates a benefit for V with a duration of 5 years, the remaining unexpired term of the lease as of the date of the termination. Because the benefit attributable to the expenditure extends beyond 12 months after the first date on which V realizes the rights or benefits attributable to the payment and beyond the end of the taxable year following the taxable year in which the
payment is made, the rules of this paragraph (f) do not apply to the payment. V must capitalize the $100,000 payment.

Example 8. Certain contract terminations. Assume the same facts as in Example 7, except the lease is terminated when it has a remaining unexpired term of 10 months. Under paragraph (f)(2) of this section, V’s payment creates a benefit for V with a duration of 10 months. The 12-month rule of this paragraph (f) applies to the payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the taxable year following the year in which the payment is made. Accordingly, V is not required to capitalize the $100,000 payment.

Example 9. Certain contract terminations. M corporation enters into a 5-year agreement with X corporation under which X is required to provide M with services over the term of the agreement. Under the terms of the agreement, either M or X may terminate the agreement without cause upon 30 days notice. M pays C, an individual, a $10,000 commission for services provided by C in locating X and bringing the parties together. The agreement between M and X is an agreement providing M the right to acquire services as described in paragraph (d)(6)(B) of this section. M’s $10,000 payment to C is an amount paid to facilitate the creation of an intangible asset as described in paragraph (c)(1)(i) of this section. Because the duration of the contract is 5 years, the 12-month rule contained in paragraph (f)(1)(i) of this section does not apply, notwithstanding the fact that the agreement is terminable by either party without cause upon 30 days notice. M must capitalize the $10,000 commission payment.

Example 10. Coordination with section 461. (i) U corporation leases office space from W corporation at a monthly rental rate of $2,000. On December 31, 2002, U prepaids its office rent expense for the first six months of 2003 in the amount of $12,000. For purposes of this example, it is assumed that the recurring item exception provided by § 1.461–5 does not apply and that the lease between W and U is not a section 467(b) rental agreement as defined in section 467(d). (ii) Under § 1.461–4(d)(3), U’s prepayment of rent is a payment for the use of property by U for which economic performance occurs ratably over the period of time U is entitled to use the property. Accordingly, because economic performance with respect to U’s prepayment of rent does not occur until 2003, U’s prepaid rent is not incurred in 2002 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2002. Thus, the rules of this paragraph (f) do not apply to U’s payment.

(iii) Alternatively, assume that U uses the cash method of accounting and the economic performance rules in § 1.461–4 therefore do not apply to U. The 12-month rule of this paragraph (f) applies to the $12,000 payment because the rights or benefits attributable to U’s prepayment of its rent do not extend beyond December 31, 2003. Accordingly, U is not required to capitalize its prepaid rent.

Example 11. Coordination with section 461. N corporation pays R corporation, an advertising and marketing firm, $40,000 on August 1, 2002, for advertising and marketing services to be provided to N through-out calendar year 2003. For purposes of this example, it is assumed that the recurring item exception provided by § 1.461–5 does not apply. Under § 1.461–4(d)(2), N’s payment arises out of the provision of services to N by R for which economic performance occurs as the services are provided. Accordingly, because economic performance with respect to N’s pre-paid advertising expense does not occur until 2003, N’s prepaid advertising expense is not incurred in 2002 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2002. Thus, the rules of this paragraph (f) do not apply to N’s payment.

(g) Treatment of capitalized transaction costs — (1) Costs described in paragraph (b)(1)(i) or (ii) of this section. Except in the case of amounts paid by an acquirer to facilitate an acquisition of stock or assets in a transaction described in section 368, an amount required to be capitalized by paragraph (b)(1)(i) or (ii) of this section is capitalized to the basis of the intangible asset acquired, created, or enhanced.

(2) Costs described in paragraph (b)(1)(iii) of this section — (i) Stock issuance or recapitalization. An amount paid to facilitate a stock issuance or a recapitalization is not capitalized to the basis of an intangible asset but is treated as a reduction of the proceeds from the stock issuance or the recapitalization.

(ii) [Reserved].

(h) Special rules applicable to pooling — (1) In general. The rules of this paragraph (h) apply to the pooling methods described in paragraph (d)(6)(ii) of this section (relating to de minimis rules applicable to certain contract rights), paragraph (e)(3)(ii)(C) of this section (relating to de minimis rules applicable to transaction costs), and paragraph (f)(5)(iii) of this section (relating to the application of the 12-month rule to renewable rights).

(2) Election to use pooling. An election to use a pooling method identified in paragraph (h)(1) of this section for any taxable year is made by establishing one or more pools for the taxable year in accordance with the rules governing the particular pooling method and the rules prescribed by this paragraph (h). An election to use a pooling method identified in paragraph (h)(1) of this section is irrevocable with respect to each pool established during the taxable year.

(3) Definition of pool. A taxpayer may use any reasonable method of defining a pool of similar transactions, agreements, or rights, including a method based on the type of customer or the type of product provided under a contract. However, a taxpayer that elects to pool similar transactions, agreements, or rights must include in the pool all similar transactions, agreements, or rights arising during the taxable year.

(4) Consistency requirement. A taxpayer that uses the pooling method described in paragraph (f)(5)(iii) of this section for purposes of applying the 12-month rule to a right or benefit — (i) Must use the pooling methods described in paragraph (d)(6)(ii) of this section (relating to de minimis rules applicable to inducements) and paragraph (e)(3)(ii)(C) of this section (relating to de minimis rules applicable to transaction costs) for purposes of determining the amount paid to create, or facilitate the creation of, the right or benefit; and

(ii) Must use the same pool for purposes of paragraph (d)(6)(ii) of this section and paragraph (e)(3)(ii)(C) of this section as is used for purposes of paragraph (f)(5)(iii) of this section.

(i) [Reserved].

(j) Application to accrual method taxpayers. For purposes of this section, the terms amount paid and payment mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of § 1.446–1(c)(1)(i)) or a liability associated with the creation of an intangible asset or recapitalization. A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(k) Treatment of related parties and indirect payments. For purposes of this section, references to a party other than the taxpayer include persons related to that party and persons acting for or on behalf of that party. Persons are related for purposes of this section only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1).

(l) Examples. The following examples illustrate the rules of this section:

Example 1. License granted by a governmental unit. (i) X corporation pays $25,000 to state R to obtain a license to sell alcoholic beverages in its restaurant. The license is valid indefinitely, provided X complies with all applicable laws regarding the sale of alcoholic beverages in state R. X pays its outside counsel $4,000 for legal services rendered in preparing the license application and otherwise representing X during the licensing process. In addition, X determines that $2,000 of salaries paid to its employees is allocable to services rendered by the employees in obtaining the license.

(ii) X’s payment of $25,000 is an amount paid to a governmental unit to obtain a license granted by that agency, as described in paragraph (d)(5)(i) of this sec-
tion. The right has an indefinite duration and constitutes an amortizable section 197 intangible. Accordingly, the provisions of paragraph (f) of this section (relating to the 12-month rule) do not apply to X’s payment. M must capitalize its $25,000 payment to obtain the license from state R.

(iii) As provided in paragraph (c)(3) of this section, X is not required to capitalize employee compensation because such amounts are treated as amounts that do not facilitate the acquisition, creation, or enhancement of an intangible asset. Thus, X is not required to capitalize the $2,000 of employee compensation allocable to the transaction.

(iv) X’s payment of $4,000 to its outside counsel is an amount paid to facilitate the creation of an intangible asset, as described in paragraph (c)(1)(i) of this section. Because X’s transaction costs do not exceed $5,000, X’s transaction costs are de minimis within the meaning of paragraph (e)(3)(i)(A) of this section. Accordingly, X is not required to capitalize the $4,000 payment to its outside counsel under this section.

Example 2. Franchise agreement. (i) R, a corporation, is a franchisor of income tax return preparation outlets. V, corporation, negotiates with R to obtain the right to operate a franchise tax return preparation outlet under a franchise from R. V pays an initial $100,000 franchise fee to R in exchange for the franchise agreement. In addition, V pays its outside counsel $4,000 to represent V during the negotiations with R. V also pays $2,000 to an industry consultant to advise V during the negotiations with R.

(ii) Under paragraph (d)(6)(i)(A) of this section, V’s payment of $100,000 is an amount paid to another party to induce that party to enter into an agreement providing V the right to use tangible or intangible property. Accordingly, V must capitalize its $100,000 payment to R. The franchise agreement is an amortizable section 197 intangible within the meaning of section 197(c). Accordingly, as provided in paragraph (f)(3) of this section, the 12-month rule contained in paragraph (f)(1)(i) of this section does not apply.

(iii) V’s payment of $4,000 to its outside counsel and $2,000 to the industry consultant are amounts paid to facilitate the creation of an intangible asset, as described in paragraph (c)(1)(i) of this section. Because V’s aggregate transaction costs exceed $5,000, V’s transaction costs are not de minimis within the meaning of paragraph (e)(3)(i)(A) of this section. Accordingly, V must capitalize the $4,000 payment to its outside counsel and the $2,000 payment to the industry consultant under this section into the basis of the franchise, as provided in paragraph (g)(1) of this section.

Example 3. Covenant not to compete. (i) On December 1, 2002, N corporation, a calendar year taxpayer, enters into a covenant not to compete with B, a key employee that is leaving the employ of N. The covenant not to compete prohibits B from competing with N for a period of 9 months, beginning December 1, 2002. N pays B $50,000 in full consideration for B’s agreement not to compete. In addition, N pays its outside counsel $6,000 to facilitate the creation of the covenant not to compete with B.

(ii) Under paragraph (d)(6)(i)(C) of this section, N’s payment of $50,000 is an amount paid to another party to induce that party to enter into a covenant not to compete with N. However, because the covenant not to compete has a duration that does not extend beyond 12 months after the first date on which N realizes the rights attributable to its payment (i.e., December 1, 2002), the 12-month rule contained in paragraph (f)(1)(i) of this section applies. Accordingly, N is not required to capitalize its $50,000 payment to B. In addition, as provided in paragraph (f)(1)(ii) of this section, N is not required to capitalize its $6,000 payment to facilitate the creation of the covenant not to compete.

Example 4. Corporate reorganization; initial public offering. Y corporation, a privately-owned company, Y’s Board of Directors authorizes an initial public offering of Y’s stock in order to fund future growth. Y pays $5,000,000 in professional fees for investment banking services related to the determination of the offering price and legal services related to the development of the offering prospectus and the registration and issuance of stock. Under paragraph (b)(1)(iii) of this section, the $5,000,000 is an amount paid to facilitate a transaction involving the acquisition of capital. As provided in paragraph (g)(2)(i) of this section, Y must treat the $5,000,000 as a reduction of the proceeds from the stock issuance.

Example 5. Demand-side management. (i) X corporation, a public utility engaging in generating and distributing electrical energy, provides programs to its customers to promote energy conservation and energy efficiency. These programs are aimed at reducing electrical costs to X’s customers, building goodwill with X’s customers, and reducing X’s future operating and capital costs. X provides these programs without obligating any of its customers participating in the programs to purchase power from X in the future. Under these programs, X pays a consultant to help industrial customers design energy-efficient manufacturing processes, to conduct “energy efficiency audits” that serve to identify for customers inefficiencies in their energy usage patterns, and to provide cash allowances to encourage residential customers to replace existing appliances with more energy-efficient appliances.

(ii) The amounts paid by X to the consultant are not amounts to acquire, create, or enhance an intangible identified in paragraph (c) or (d) of this section or to facilitate such an acquisition, creation, or enhancement. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to B, C, and D are not required to be capitalized under this section. While the amounts produce long term benefits to V in the form of reduced inventory stockpiles, improved product quality, and increased efficiency, these benefits, without more, are not intangible assets for which capitalization is required under this section unless the Internal Revenue Service publishes guidance identifying these benefits as an intangible asset for which capitalization is required.

Example 7. Defense of business reputation. (i) X, an investment adviser, serves as the fund manager of a money market investment fund. X, like its competitors in the industry, strives to maintain a constant net asset value for its money market fund of $1.00 per share. During 2003, in the course of managing the fund assets, X incorrectly predicts the direction of market interest rates, resulting in significant investment losses to the fund. Due to these significant losses, X is faced with the prospect of reporting a net asset value that is less than $1.00 per share. X is not aware of any investment adviser in its industry that has ever reported a net asset value for its money market fund of less than $1.00 per share. X is concerned that reporting a net asset value of less than $1.00 per share will significantly harm its reputation as an investment adviser, and could lead to litigation by shareholders. X decides to contribute $2,000,000 to the fund in order to raise the net asset value of the fund to $1.00 per share. This contribution is not a loan to the fund and does not give X any ownership interest in the fund.

(ii) The $2,000,000 contribution is not an amount paid to acquire, create, or enhance an intangible identified in paragraph (c) or (d) of this section or to facilitate such an acquisition, creation, or enhancement. In addition, the amount does not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amount contributed to the fund is not required to be capitalized under this section. While the amount serves to protect the business reputation of the taxpayer and may protect the taxpayer from litigation by shareholders, these benefits, without more, are not intangible assets for which capitalization is required under this section unless the Internal Revenue Service publishes guidance identifying these benefits as an intangible asset for which capitalization is required.
(m) **Amortization.** For rules relating to amortization of certain intangible assets, see §1.167(a)–3.

(n) **Intangible interests in land.** [Reserved]

(o) **Effective Date** — (1) **In general.** This section applies to amounts paid or incurred on or after the date the final regulations are published in the Federal Register.

(2) **Automatic consent to change method of accounting.** A taxpayer seeking to change a method of accounting to comply with this section must follow the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner’s automatic consent to a change in accounting method (Revenue Procedure 2002–9 or its successor). Any change in method of accounting to comply with this section must be made using an adjustment under section 481(a). However, for this purpose, the adjustment under section 481(a) is determined by taking into account only amounts paid or incurred on or after the date the final regulations are published in the Federal Register. The final regulations may provide additional terms and conditions for changes under this paragraph (o)(2).

Par. 4. Section 1.446–5 is added to read as follows:

§ 1.446–5 Debt issuance costs.

(a) **In general.** This section provides rules for allocating debt issuance costs over the term of the debt. For purposes of this section, the term debt issuance costs means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under §1.263(a)–4(e). If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under paragraph (b) of this section.

(b) **Method of allocating debt issuance costs** — (1) **In general.** Solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See §1.1273–2 to determine issue price. Thus, debt issuance costs increase or create original issuance discount and decrease or eliminate bond issuance premium.

(2) **Original issue discount.** Any resulting original issue discount is taken into account by the issuer under the rules in §1.1163–7, which generally require the use of a constant yield method (as described in §1.1272–1) to compute how much original issue discount is deductible for a period. However, see §1.1163–7(b) for special rules that apply if the total original issue discount on the debt is de minimis.

(3) **Bond issuance premium.** Any remaining bond issuance premium is taken into account by the issuer under the rules of §1.1163–13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

(c) **Example.** The following example illustrates the rules of this section:

Example. (i) On January 1, 2004, X borrows $10,000,000. The principal amount of the loan ($10,000,000) is repayable on December 31, 2008, and payments of interest in the amount of $500,000 are due on December 31 of each year the loan is outstanding. X incurs debt issuance costs of $130,000 to facilitate the borrowing.

(ii) Under §1.1273–2, the issue price of the loan is $10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of $130,000, resulting in an issue price of $9,870,000. As a result, X treats the loan as having original issue discount in the amount of $130,000 (stated redemption price at maturity of $10,000,000 minus the issue price of $9,870,000). Because this amount of original issue discount is more than a de minimis amount (within the meaning of §1.1273–1(d)), X must allocate the original issue discount to each year based on the constant yield method described in §1.1272–1(b). See §1.1163–7(a). Based on this method and a yield of 5.30%, compounded annually, the original issue discount is allocable to each year as follows: $23,385 for 2004, $24,625 for 2005, $25,931 for 2006, $27,306 for 2007, and $28,753 for 2008.

(d) **Effective date.** This section applies to debt issuance costs incurred for debt instruments issued on or after the date final regulations are published in the Federal Register.

(e) **Accounting method changes** — (1) **Consent to change.** An issuer required to change its method of accounting for debt issuance costs to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446–1(e). Paragraph (e)(2) of this section provides the Commissioner’s automatic consent for certain changes.

(2) **Automatic consent.** The Commissioner grants consent for an issuer to change its method of accounting for debt issuance costs incurred for debt instruments issued on or after the date final regulations are published in the Federal Register. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (e)(2) applies provided—

(i) The change is made to comply with this section;

(ii) The change is made for the first taxable year for which the issuer must account for debt issuance costs under this section; and

(iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

David A. Mader, Assistant Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 18, 2002, 8:45 a.m., and published in the issue of the Federal Register for December 19, 2002, 67 F.R. 77701)

**Correction to Rev. Proc. 2003–7**

**Announcement 2003–4**

**PURPOSE**


**EFFECTIVE DATE**

This announcement is effective as of January 6, 2003, the effective date of publication of Rev. Proc. 2003–7 in 2003–1 I.R.B. 233.

**EFFECT ON OTHER DOCUMENTS**


**DRAFTING INFORMATION**

The principal author of this announcement is Gerard Traficanti of the Office of the Associate Chief Counsel (International).
Supplementary Information:

Background

Section 330 of title 31 of the United States Code authorizes the Secretary of the Treasury to regulate the practice of representatives before the Treasury Department and, after notice and an opportunity for a proceeding, to suspend or disbar from practice before the Treasury Department those representatives who are incompetent, disreputable, or who violate regulations prescribed under section 330. Pursuant to section 330, the Secretary, in Circular No. 230 (31 CFR part 10), published regulations that authorize the Director of Practice to act upon applications for enrollment to practice before the Service, to institute proceedings for suspension or disbarment from practice before the Service, to make inquiries with respect to matters under the Director's jurisdiction, and to perform such other duties as are necessary to carry out these functions.

The regulations were most recently amended on July 26, 2002, (T.D. 9011, 2002–33 I.R.B. 356 [67 FR 48760]) to clarify the general standards of practice before the Service. In the preamble to those amendments to the regulations, the Treasury Department and the Service stated their intention to issue a second notice of proposed rulemaking to re-propose amendments to regulations governing standards for tax shelter opinions. The Treasury Department and the Service also stated their intention to issue an advanced notice of proposed rulemaking covering additional nonshelter matters pertaining to practice before the Service.

Contemporaneously with the efforts to address issues affecting practice, the Treasury Department and the Service are reorganizing the Office of the Director of Practice to enhance its effectiveness. As part of the reorganization, the authority to supervise the Office of the Director of Practice has been delegated to the Office of the Senior Counselor to the Commissioner. The authority to make the agency decision in disciplinary proceedings when decisions by Administrative Law Judges are appealed has also been delegated to the Senior Counselor to the Commissioner. The Office of Senior Counselor to the Commissioner observes an “ethical wall” ensuring that the official who makes the agency decision in such disciplinary proceedings is not exposed to these cases prematurely. Another step in the reorganization is the possible renaming of the Office of the Director of Practice to the Office of Professional Responsibility. It also is contemplated that the Office of Senior Counselor to the Commissioner will have a centralized role in the selection of the Director of Practice. The Treasury Department and the Service are seeking public comment on this reorganization.

Special Analyses

It has been determined that this advance notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866.

Request for Comments

The Treasury Department and the Service invite comments on the following matters.

Director of Practice

1. Whether §10.1 should be revised to rename the Director of Practice as the Director of Practice?

2. Whether the authority to appoint the Director of Practice should be delegated to the Office of the Director of Professional Responsibility?

3. Whether the authority to appoint the Director of Practice should be delegated to the Office or person who supervises the Director of Practice?

Definition of Practice and Who May Practice

1. Whether the definition of practice before the Service and the definition of practitioner in §10.2 should be modified to specifically provide that return preparation by an individual not described in §10.3(a) through (d) (“unenrolled return preparer”) is practice before the Service and that an unenrolled return preparer is a practitioner under Circular 230.

2. Whether §10.3(b) should be revised to permit licensed accountants, and certi-
fied internal auditors, who are not certified public accountants, to practice before the Service.

3. Whether § 10.7(c)(1)(viii) should be revised to authorize the Director of Practice to modify the scope of limited practice by unenrolled return preparers, without further amendment to the regulations.

4. Whether the regulations should specifically provide the Director of Practice with authority to determine eligibility for limited practice by unenrolled return preparers under § 10.7(c)(1)(viii).

Enrolled Agents and Eligibility for Enrollment

1. Whether Enrolled Agents should be allowed to refer to themselves as “Licensed Tax Professionals” or another specified designation determined by the Service, in addition to or instead of the Enrolled Agent designation, to more fully describe the nature of the professional services that they provide.

2. Whether the regulations should set forth specific examples of acceptable descriptions of an Enrolled Agent’s practice for advertisements.

3. Whether the Director of Practice should be authorized to determine, without requiring further amendment of the regulations, standards for the continuing professional education requirements of Enrolled Agents.

Sanctions and Disciplinary Proceedings

1. Whether the regulations should be amended to authorize a practitioner and the Director of Practice to enter into settlement agreements, with such agreements enforceable through the expedited procedures of § 10.82.

2. Whether the definition in the regulations of disreputable conduct should be amended to specifically include the willful failure of a practitioner who is a preparer to sign a return.

3. Whether, in order to facilitate the timely adjudication of disciplinary proceedings instituted under § 10.60, the regulations should be amended to provide that the failure of a practitioner to answer a complaint constitutes an automatic default in the proceeding, subject to a showing of good cause.

4. Whether the regulations should be amended to provide the parties to a proceeding instituted under § 10.60 the opportunity to obtain discovery through means such as interrogatories, requests for production of documents, and requests for admissions, in addition to depositions. Whether the regulations should define what discovery should be permitted. Whether the regulations should place limits on discovery.

5. Whether the protection afforded in the current regulation — that a party in a disciplinary proceeding is entitled to present his case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross examination as may be required for a full and true disclosure of the facts — is sufficient, or whether changes should be made to afford greater protection in a disciplinary proceeding, including the opportunity to question, in the presence of the Administrative Law Judge, any person whose statement is offered by the opposing party.

Contingent fees

1. Whether contingent fees should be permitted in conjunction with a request for a private letter ruling or other prefiling document.

2. Whether the regulations should continue to permit a practitioner to charge a contingent fee for preparing, or for any advice rendered in connection with a position taken or to be taken on, an amended return or claim for refund.

3. Whether the prohibition on contingent fees should be expanded to permit contingent fees only for amended returns or claims for refund when the client’s taxable income on the amended return or claim for refund is less than $50,000 (or another amount determined with reference to financial need).

Confidentiality Agreements

1. Whether the regulations should prohibit practitioners from entering into agreements with clients that, in violation of applicable state professional rules or applicable state law, restrict a practitioner from providing relevant tax advice to other similarly situated taxpayers.

2. Whether the regulations should prohibit, irrespective of applicable state professional rules or applicable state law, the agreements identified above.

Pamela F. Olson,
Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on December 18, 2002, 8:45 a.m., and published in the issue of the Federal Register for December 19, 2002, 67 F.R. 77724)
Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:

**Amplified** describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with modified, below).

**Clarified** is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

**Distinguished** describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

**Modified** is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with amplified and clarified, above).

**Obsoleted** describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

**Revoked** describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

**Superseded** describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, **modified** and **superseded** describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

**Supplemented** is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

**Suspended** is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
CI—City.
COOP—Cooperative.
Cl.D.—Court Decision.
CT—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
EX—Executor.
F—Fabricator.
FC—Foreign Country.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FX—Foreign Corporation.
G.C.M.—Chief Counsel’s Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
LE—Lessor.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFR—Transferor.
T.F.R.—Transferor.
TP—Taxpayer.
TR—Trust.
TR—Trustee.
X—Corporation.
Y—Corporation.
Z—Corporation.
Numerical Finding List

Announcements:
2003–2, 2003–3 I.R.B. 301

Notices:

Proposed Regulations:

Revenue Procedures:
2003–1, 2003–1, I.R.B. 1
2003–2, 2003–1, I.R.B. 76
2003–3, 2003–1, I.R.B. 113
2003–4, 2003–1, I.R.B. 123
2003–6, 2003–1, I.R.B. 191
2003–8, 2003–1, I.R.B. 236

Revenue Rulings:
2003–9, 2003–4 I.R.B. 303

Finding List of Current Actions on Previously Published Items

Notices:

97–19
Modified by

2001–46
Modified by

2001–69
Modified and superseded by

2002–27
Clarified by

Revenue Procedures:

84–37
Modified by

93–38
Obsoleted by

2002–1
Superseded by

2002–2
Superseded by

2002–3
Superseded by

2002–4
Superseded by

2002–5
Superseded by

2002–6
Superseded by

2002–7
Superseded by

2002–8
Superseded by

2002–9
Modified and amplified by

Revenue Procedures—Continued:

2002–22
Modified by

2002–29
Modified by

2002–52
Modified by

2002–67
Supplemented by

2002–75
Superseded by

2003–3
Amplified by

Revenue Rulings:

53–131
Modified by

65–190
Revoked by

69–372
Revoked by

Supplement to Internal Revenue Bulletin 2003–5
February 3, 2003

INDEX
Internal Revenue Bulletins
2003-1 through 2003-4

The abbreviation and number in parenthesis following the index entry refer to the specific item; numbers in roman and italic type following the parenthesis refer to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

Key to Abbreviations:
Ann Announcement
CD Court Decision
DO Delegation Order
EO Executive Order
PL Public Law
PTE Prohibited Transaction Exemption
RP Revenue Procedure
RR Revenue Ruling
SPR Statement of Procedural Rules
TC Tax Convention
TD Treasury Decision
TDO Treasury Department Order

EMPLOYEE PLANS

Advance letter rulings and determination letters, areas which will not be issued from:
Associates Chief Counsel and Division Counsel/Associate Chief Counsel (TE/GE) (RP 3) 1, 113
Associate Chief Counsel (International) (RP 7) 1, 233

Defined benefit plans, required minimum distributions (Notice 2) 2, 257

Determination letters, issuing procedures (RP 6) 1, 191

Employee stock ownership plans, delayed distributions (Notice 2) 2, 257

Full funding limitations, weighted average interest rate for:
January 2003 (Notice 7) 2, 310

Individual retirement arrangements:
Deemed IRAs (RP 13) 4, 317
Required minimum distributions (Notice 3) 2, 258

EXEMPT ORGANIZATIONS—Cont.

Letter rulings:
- Determination letters and information letters issued by Associates Chief Counsel and Division Counsel/Associate Chief Counsel (TE/GE) (RP 1) 1, 1
- Information letters, etc. (RP 4) 1, 123

Limitation on annual compensation, nondiscrimination (RR 11) 3, 285

Nondiscrimination, governmental plans (Notice 6) 3, 298

Proposed Regulations:
- 26 CFR 1.401(a)(3) (RR 9) 3, 292

Qualified retirement plans:
- Age discrimination (REG–209500–86, REG–164464–02) 2, 262

Technical advice:
- Proposed cash balance regulations, age discrimination issues (Ann 1) 2, 281
- To directors and chiefs, appeals offices, from Associates Chief Counsel and Division Counsel/Associate Chief Counsel (TE/GE) (RP 2) 1, 76
- To IRS employees (RP 5) 1, 163
- User fees, request for letter rulings (RP 8) 1, 236

2003-5 I.R.B. iv

February 3, 2003
INCOME TAX—Cont.

Forms: 8883, Asset Allocation Statement
Under Section 338, new (Ann 2) 3, 301
Information reporting on Form 1099–B
for securities futures contracts (Notice 8) 4, 310

Insurance companies, recomputed differential earnings rate for 2000 and the
differential earnings rate for 2001 for mutual life insurance companies (RR 4)
2, 253

Interest:
Investment:
Federal short-term, mid-term, and
long-term rates for:
January 2003 (RR 5) 2, 254

Inventory:
LIFO, price indexes used by depart-
ment stores for:
November 2002 (RR 9) 4, 303

Leave-based donation programs (Notice 1) 2, 257
Letter rulings, determination letters and
information letters issued by Associates
Chief Counsel and Division Counsel/
Associate Chief Counsel (TE/GE) (RP 1) 1, 1

LIFO recapture installment payments
(Notice 4) 3, 294
Offshore Voluntary Compliance Initiative
(RP 11) 4, 311

Presidentially declared disaster, gross
income, disaster relief payments (RR 12) 3, 283

Proposed Regulations:
26 CFR 1.61–8, revised; rents and roy-
alties (REG–151043–02) 3, 300
Qualified census tracts, issuers of qualifi-
ced mortgage bonds and mortgage
credit certificates (RP 15) 4, 321

Rents and royalties, inclusion of advance
rentals in gross income (REG–151043–
02) 3, 300

Soil and Water Conservation Assistance
Program (SWCA) (RR 14) 4, 302
State tax refunds, accrual of income (RR
3) 2, 252

Technical advice to:
Directors and chiefs, appeals offices,
from Associates Chief Counsel and
Division Counsel/Associate Chief
Counsel (TE/GE) (RP 2) 1, 76
IRS employees (RP 5) 1, 163
Trusts for minors, Indian Gaming Regu-
latory Act (IGRA) (RP 14) 4, 319