Report No. 1031

New York State Bar Association Tax Section

Report on Notice of Proposed Rulemaking on Deduction and Capitalization of Expenditures Relating to Intangibles

This report[1] comments on proposed regulations (the "Proposed Regulations")[2] explaining how Section 263(a)[3] applies to amounts paid to acquire, create or enhance intangible assets. The Proposed Regulations are intended to implement the advance notice of proposed rulemaking issued by the Treasury Department (the "Treasury") and the Internal Revenue Service (the "IRS") in January 2002 (the "Notice"), which was the subject of a previous report by the Tax Section.[4]

Generally, the Proposed Regulations follow the approach that was outlined in the Notice. The Proposed Regulations provide that expenditures incurred to acquire intangibles from a third

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[1] This report was prepared by the Committee on Tax Accounting of the Tax Section of the New York State Bar Association. The principal drafter of this report was David Mayo, with substantial contributions from Marci Poliakoff. Helpful comments were received from Michele Alexander, Kimberly Blanchard, Peter Canellos, Andrew Fabens, Peter Faber, David Kahen, Jonathan Kushner, Michael Schler, Marc Silberberg, Burton Smoliar and Elias Tzavelis.

[2] REG-125638-01, 67 F.R. 77701-01 (Dec. 19, 2002).

[3] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code").

[4] Guidance Regarding Deduction and Capitalization of Expenditures, 67 Fed. Reg. 3461-02; New York State Bar Association Tax Section, Report on Advance Notice of Proposed Rulemaking on Deduction and Capitalization of Expenditures Connected with Intangibles (July 25, 2002) (the "2002 Report").

party are required to be capitalized.[5] Expenditures that are incurred to create or enhance intangibles that are identified in specific categories in the Proposed Regulations also are required to be capitalized; unlike the categories of acquired intangibles, these categories are exclusive, meaning that no costs to create or enhance other intangibles are required to be capitalized.[6] The Proposed Regulations provide that additional categories of intangibles for which creation and enhancement expenditures are required to be capitalized can be identified by published guidance.[7] Such guidance, having prospective effect, will be issued with respect to designated expenditures that produce a future benefit significant enough to warrant capitalization.

The Proposed Regulations also provide that transaction costs incurred to facilitate the acquisition, creation or enhancement of an intangible asset are required to be capitalized.[8] Employee compensation and general overhead costs, however, are not required to be capitalized, nor are most costs that do not exceed a de minimis amount of $5,000.[9] In addition, subject to limited exceptions, no costs are required to be capitalized if the expected benefits of the intangible to the taxpayer do not extend beyond the earlier of 12 months after the first date on which the taxpayer realizes benefits or the end of the taxable year following the taxable year in

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5 Prop. Treas. Reg. § 1.263(a)-4(c) (including a non-exclusive list of intangibles the acquisition costs of which are required to be capitalized).

6 Prop. Treas. Reg. § 1.263(a)-4(d)(1).

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

8 Prop. Treas. Reg. § 1.263(a)-4(e).

9 Prop. Treas. Reg. § 1.263(a)-4(e)(3).

which the expenditure was made.[10] The remainder of this report will comment on issues that are raised by the Proposed Regulations.

I. Summary.

We commend the Treasury and the IRS for issuing Proposed Regulations in this difficult area. We believe that the general approach of the Proposed Regulations provides a practical solution to many difficult conceptual problems relating to capitalization and, as we noted in the 2002 Report, will create clarity and reduce litigation and administrative costs associated with capitalization issues. Although in formulating workable rules, the Treasury and IRS arguably departed in some instances from a theoretically correct result, we view this as a wise decision given the benefit of significantly enhanced clarity in this area.

We endorse the overall approach of the Proposed Regulations of identifying specific categories of expenditures that must be capitalized and we view the addition of a procedure to expand the categories of expenditures required to be capitalized as a material improvement over the proposal described in the Notice. We believe, however, that the Final Regulations should make clear that those categories of expenditures identified as requiring capitalization be construed broadly. To do otherwise could invite taxpayers to take aggressive positions based on relatively insignificant distinctions from the expenditures for which capitalization is required.

We generally support the approach taken by the Proposed Regulations as to the treatment of business acquisition costs. We recommend, however, that a mechanism be created to provide for the recovery of target's costs in a taxable stock acquisition at an appropriate time earlier than its liquidation, in particular at the time the stock of target is sold. We believe that transaction

[10] Prop. Treas. Reg. § 1.263(a)-4(f).

costs of tax-free and partially tax-free reorganization transactions, as well as costs in Section 351 transactions and tax-free spin-offs, should not be added to the basis of either the stock or assets acquired, and therefore no recovery, except possibly on liquidation of the corporation incurring the costs, would be available for such costs.

II. General Comments.

In the 2002 Report, we endorsed the general approach of the Notice of creating categories of intangibles for which creation and enhancement expenditures are required to be capitalized, although we suggested that the Treasury and the IRS promulgate a general rule requiring capitalization of certain expenditures not enumerated in the categories. The approach set out in the Notice has been carried out in the Proposed Regulations. We view this as a significant step in reducing the uncertainty and controversy surrounding the treatment of such expenditures. Further, we believe that the Treasury and the IRS, based on their experience in the area, were able to identify most categories of expenditures for which capitalization is appropriate, and therefore determined that it was appropriate to avoid a "general rule" in order to reduce controversy and enhance administrability of the regulations. This is particularly the case in light of the establishment of a procedure for providing new categories through published guidance, which will enhance the flexibility of the IRS to respond to changing circumstances and is a material improvement over the proposal outlined in the Notice.

In the 2002 Report, however, we expressed the concern that the approach of defining particular categories requiring capitalization would be subject to abuse, because taxpayers would seek to deduct expenditures based on immaterial distinctions between those expenditures and expenditures included in the listed categories. We suggested that the Treasury and the IRS take care in the regulations to emphasize the broad nature of the categories to combat this potential abuse, both by example and perhaps by providing a general rule or a rule of interpretation that the categories are to be construed broadly. We continue to believe that such an approach is necessary for an administrable set of rules, particularly in the absence of a general rule requiring capitalization in certain circumstances. Accordingly, we urge the Treasury and the IRS to include such a statement either in the final regulations or in their preamble and to expand the limited number of examples relating to this point to further indicate that an expansive reading of the categories is appropriate.[11]

III. Business Acquisition Costs.

The Treasury and the IRS sought comments on a number of aspects of the treatment of transaction costs incurred (a) to acquire the stock or assets of a corporation, (b) to raise capital and (c) in connection with changes to the capital structure of a business, such as through recapitalizations and spin-offs. Under current law, the costs of the acquiror incurred to acquire stock or assets are capitalized into the cost of the stock or assets acquired, and costs incurred to acquire capital generally are treated as reductions of the amount of capital acquired.[12] Costs incurred by the target, on the other hand, either decrease proceeds in an asset sale or are capitalized in a stock sale.[13] Costs capitalized into the basis of stock are recovered only when the stock is sold, and costs incurred to acquire other assets are recovered as those assets are

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[11] One example in the Proposed Regulations, in which a payment that is described by the parties as a "sales discount" but is treated in the example as a payment to induce the buyer to enter into the sale contract, apparently indicates that an expansive reading should be given to at least that category. Prop. Treas. Reg. § 1.263-4(d)(2)(iv) Ex. 5.

[12] See, e.g., Woodward v. Commissioner, 397 U.S. 572 (1970) (requirement of capitalization); Rev. Rul. 69-330, 1969-1 C.B. 51 (reduction of proceeds).

[13] INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) (target corporation professional fees required to be capitalized).

depreciated or sold.[14] On the other hand, investigative costs incurred in connection with an acquisition are treated as start-up expenditures under the so-called "whether and which" test of Revenue Ruling 99-23 and are amortizable over a five-year period.[15]

A. Capitalization versus Deduction of Costs of Acquisition.

1. Summary.

The Proposed Regulations provide that amounts paid to facilitate a transaction must be capitalized if the amounts are paid in the process of pursuing the transaction.[16] Generally, the determination of whether an amount is paid in the process of pursuing a transaction is based on the facts and circumstances.[17] In the case of a restructuring, reorganization, or acquisition of capital, the Proposed Regulations provide a two-part test, which is intended to be a bright-line test, for determining whether a particular cost that is not otherwise deductible pursuant to the Proposed Regulations (for example, pursuant to the rule for employee compensation) is deductible or is required to be capitalized. The first part of the test provides that certain types of expenses are considered to be "inherently facilitative" of an acquisition, and therefore are

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14 In the case of asset acquisitions of entire trades or businesses, costs incurred that do not relate to specific assets will be treated as additional purchase price for goodwill under the residual method and will be recovered over 15 years pursuant to Section 197. See Treas. Reg. § 1.1060-1(c); Treas. Reg. § 1.338-6(b)(2). Target costs in a stock transaction generally are recovered only on liquidation. Cf. INDOPCO, 503 U.S. at 84 (stating in dicta that capitalized expenditures for assets with no ascertainable useful life are recovered on liquidation of the taxpayer).

15 Revenue Ruling 99-23, 1999-1 C.B. 998, held that expenditures incurred in the course of a general search for, or investigation of, an active trade or business in order to determine whether to enter a new business and which new business to enter generally qualify as investigatory costs that are eligible for amortization as start-up expenditures under Section 195. In contrast, expenditures incurred in the attempt to acquire a specific business were required by the ruling to be capitalized. The determination of the classification of each expenditure was to be based on the facts and circumstances of the transaction.

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

17 Id.

required to be capitalized regardless of the stage of the acquisition process at which they are incurred.[18] Pursuant to the second part of the test, all other amounts incurred to facilitate an acquisition, regardless of the particular nature of the costs, must be capitalized if they are incurred on or after the earlier of (1) the date on which the acquiror submits to the target a letter of intent, offer letter, or similar written communication proposing an acquisition or (2) the date on which an acquisition proposal is approved by the taxpayer's Board of Directors or other appropriate governing body.[19] The latter rule replaces the "whether or which" rule of Revenue Ruling 99-23, which lead to controversy. Other amounts paid in connection with the acquisition of stock or assets, such as severance costs and integration costs, are not required to be capitalized, even if they would not have been paid "but for" the acquisition.[20]

Comments were requested regarding whether this bright-line test would be administrable and whether other bright-line standards can be applied in this area. We view the general approach as an improvement to that provided by Revenue Ruling 99-23 and the common law. Subject to the limited comments below, we support the approach of treating certain expenditures as always subject to capitalization and have few issues with the list of inherently facilitative costs. Similarly, we believe that the bright-line cutoff for current deductibility based on a

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[18] Prop. Treas. Reg. § 1.263(a)-4(e)(4)(i)(B). The Proposed Regulations include an apparently exclusive list of inherently facilitative costs, which are costs incurred to (1) determine the value of the target, (2) negotiate or structure the transaction, (3) prepare and review transactional documents, (4) prepare and review regulatory filings required by the transaction, (5) obtain regulatory approval of the transaction, (6) secure advice regarding the tax consequences of the transaction, (7) secure a fairness opinion, (8) obtain shareholder approval of the transaction, or (9) convey property between the parties to the transaction. Id. In addition, success-based fees are treated as inherently facilitative except to the extent that evidence clearly demonstrates that some portion of the amount is allocable to activities that do not facilitate the acquisition. Prop. Treas. Reg. § 1.263(a)-4(e)(4)(i)(C).

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

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

number of objective events is an appropriate approach to reduce controversy while recognizing that certain costs in an acquisition may be properly deductible on a current basis.

2. Inherently Facilitative.

In general, we view the list of inherently facilitative expenditures as both appropriate and inclusive. Although not stated expressly, it appears that the primary costs required to be capitalized by the second part of the rule, but not the first part, are due diligence costs.[21] We question the distinction drawn in the Proposed Regulations between due diligence costs and enumerated costs. For a potential purchaser, due diligence review serves a number of purposes simultaneously, among them becoming acquainted with the potential target's business and its corporate structure, determining potential liabilities that might make the target an undesirable investment, and examining operational, financial and other information to determine the target's value. In short, due diligence review enables a potential purchaser to determine both whether to purchase the target and, in significant part, how much to pay for the target.

The Proposed Regulations treat due diligence costs as distinct from costs incurred to determine the value of the target, only the latter requiring capitalization as inherently facilitative. Notwithstanding the mixed benefits provided by due diligence, we believe such result is appropriate, because imposing on would-be acquirors the burden of allocating due diligence tasks to separate costs incurred to determine the target's value from those incurred for other matters would be impractical and would undermine the Proposed Regulations' goals of simplicity and administrability. This particularly would be the case because such an allocation would be required only for costs incurred before the date that a letter of intent, or similar

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[21] Prop. Treas. Reg. § 1.263(a)-4(e)(7) Ex. 9 (providing that due diligence costs incurred before the letter of intent is delivered are not required to be capitalized).

communication, was delivered. Accordingly, we suggest that the final regulations expressly provide that all due diligence costs incurred before the date after which all costs are required to be capitalized be deductible currently, regardless of the tasks performed or whether those tasks may be related to determining the value of the target. In addition, we suggest that the final regulations eliminate any ambiguity regarding due diligence costs by more clearly describing the costs intended to be encompassed in the category of inherently facilitative valuation expenditures. In our view, the latter should be limited to appraisals or other formal valuations which, in our experience, more often are obtained later in the acquisition process to support allocations of consideration or otherwise.

3. Cut Off of Current Deduction.

We support the decision to establish a bright line beyond which all expenditures are required to be capitalized. We believe that the guiding principles for the timing prong of the bright-line rule should be that the specified event should be readily identifiable and should serve as a proxy for the point beyond which all costs incurred in connection with the acquisition are likely to be those listed in the “inherently facilitative” category. After such event has occurred, we believe it would be administratively more convenient and efficient to require capitalization of all costs rather than to continue to analyze each expenditure separately. As discussed above, the primary effect of the application of the second part of the test in the Proposed Regulations appears to require the capitalization of costs incurred in connection with due diligence after the cut off date.

We believe that the benchmarks listed in the Proposed Regulations are appropriate examples of events after which all expenses tend to be inherently facilitative of an acquisition. In our view, the referenced documents are likely to be issued only after substantial consideration has been given to the transaction and only after significant terms, including but not limited to pricing, have been discussed and perhaps agreed to. Further, it is unlikely that delivery of such documents would be postponed in order to obtain a deduction for otherwise nondeductible expenses. We recommend, however, that the regulations be expanded to provide examples of additional benchmarks.[22] For example, we believe that the submission of a bid letter in an auction setting should be sufficient to require costs incurred after its submission to be required to be capitalized. Submission of a bid, like a letter of intent, indicates that the potential acquiror has developed a view as to the value of the target.[23] In addition, a draft acquisition agreement often is submitted with a bid, indicating that consideration has been given to the other significant terms of the transaction. Diligence conducted after a bid is submitted for a specified price generally serves as a basis for contract negotiation and the drafting of schedules, all of which would fall under the inherently facilitative category.[24] For the avoidance of doubt, we recommend that the signing of transaction documents themselves be included as a benchmark in order to clarify that such documents, even if subject to a board approval condition, would trigger the capitalization requirement.

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[22] Although we view price and other significant terms as important indications that the communication reflects a decision to go forward with a transaction, we do not believe that the regulations should require any particular terms to be in the document for the document to serve as the cut off. To do so would merely create an incentive to avoid stating those terms, while otherwise accomplishing the particular objective of the communication, in order to continue to deduct costs.

[23] We recognize that not all bidders expend significant effort before making an initial bid. Although the facts and circumstances relating to each auction are different, and significant costs may be incurred in the auction process after a bid is made but before a bid is accepted, we view submission of an initial bid as a significant enough step to warrant its being a triggering event, even though for some bidders the rule may be over-inclusive in requiring capitalization.

[24] Of course, if a bid is rejected, the taxpayer would be entitled to deduct currently all costs incurred in connection with the failed attempt at the acquisition. <u>See</u> Section 165; <u>cf.</u> Prop. Treas. Reg. § 1.263(a)-4(e)(7) Ex. 9.

We also recommend that the regulations expressly address the treatment of commonly-occurring formal communications that would not trigger the requirement to capitalize all expenditures. For example, we believe that entering into an exclusivity agreement should not serve as a triggering event. These agreements generally do not contain a specified price and resemble, at most, options to acquire a target. After exclusivity agreements are entered into, many due diligence activities that are not inherently facilitative likely would be conducted before a letter of intent or a similar document would be agreed to. Similarly, confidentiality agreements generally are signed very early in the acquisition process and do not contain a price or any level of certainty that the acquisition will take place. Generally, a confidentiality agreement will be signed before any due diligence review has commenced. Because of the lack of commitment and the early stage at which these documents are entered into, we believe that the final regulations should specify that these and similar formal communications do not trigger the requirement that all transaction expenses be capitalized.

4. Hostile Takeover Defense.

Consistent with current case law, the Proposed Regulations provide that costs incurred to defend against a hostile acquisition are not required to be capitalized because they do not facilitate a transaction.[25] They also provide that when an acquisition attempt ceases to be hostile, an amount paid by the taxpayer in the process of pursuing the now-friendly acquisition is

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[25] Prop. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A). See generally A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482 (7th Cir. 1997) (investment banking and other costs incurred in connection with defense of a hostile takeover, to the extent that they did not facilitate the ultimate acquisition, permitted to be deducted on a current basis).

an amount paid to facilitate a transaction and, therefore, must be capitalized.[26] Comments were requested as to how to determine when a hostile acquisition ceases to be hostile.

A hostile takeover (or a takeover that commences as a hostile takeover) will almost always occur in a public company context, and generally will be initiated by a tender offer, a proxy contest or a so-called "bear hug" letter. In the case of a tender offer, we believe that a bright line signifying the end of the "hostile" period can be drawn on the basis of filings that will be required with the Securities and Exchange Commission (the "SEC"). As soon as practicable on the date of commencement, a bidder in a tender offer must file a Schedule TO with the SEC and deliver a copy to the target setting forth, among other things, the terms and conditions of the offer.[27] Within 10 business days from the date the Schedule TO is given, the target must publish or send its security holders a statement disclosing whether it recommends acceptance or rejection of the offer, which statement must be filed with the SEC on Schedule 14D-9 as soon as practicable on the date it is first published or sent to security holders.[28] If any material change occurs in the information set forth in the Schedule 14D-9, including, for example, a change in the target's recommendation, the person who filed the Schedule 14D-9 must file an amendment promptly, but not later than the date such information is published or given to security holders.[29] In our view, the filing of a Schedule 14D-9 that changes the target's recommendation signifies that the transaction no longer is hostile. We believe that such a filing is very unlikely to be

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

[27] Sec. Exch. Act of 1934, 17 C.F.R. § 240.14d-3(a)(1) and (2).

[28] Sec. Exch. Act of 1934, 17 C.F.R. § 240.14e-2; Sec. Exch. Act of 1934, 17 C.F.R. § 240.14d-9(b) and (g).

[29] Sec. Exch. Act of 1934, 17 C.F.R. § 240.14d-9(c).

delayed merely to provide a tax benefit in light of the business realities surrounding such a filing and the securities law penalties that would attach to a failure to file.

In the case of a proxy contest or a "bear hug" letter (that is, a communication with target that suggests the possibility of a combination with the express or implied suggestion of a follow-on hostile takeover if target refuses to negotiate a friendly deal), no single bright line would be available. A proxy contest for control of the board would be initiated by the filing with the SEC of a Proxy Statement on Schedule 14A by the person soliciting votes in favor of new board members.[30] The target's board would also file its own Proxy Statement, soliciting votes in favor of the incumbent board. There is no immediate trigger that would require a new filing were the target's board to agree to a takeover proposal, other than a public announcement of its intention to sign a merger agreement (which is not required) or the signing of a merger agreement, either of which would require the filing of a Current Report on Form 8-K within 15 calendar days. Likewise, the initiation of a hostile proposal by a bear hug does not involve a clear demarcation between the friendly and the hostile periods. Accordingly, we recommend that in the case of a proxy contest or bear hug, the final regulations provide that a hostile takeover is treated as friendly from the time that, based on all of the facts and circumstances, the target supports the occurrence of a transaction. Relevant facts and circumstances would include court filings, public statements and internal communications of the target. We recognize that the lack of a bright-line rule could result in controversy, but a facts and circumstances approach seems unavoidable in this context.

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[30] Sec. Exch. Act of 1934, 17 C.F.R. § 240.14a-3(a).

B. Recovery of Acquisition Costs that are Required to be Capitalized.

1. In General.

Pursuant to the Proposed Regulations, costs of the acquisition, creation or enhancement of an intangible asset that are required to be capitalized and that do not have a reasonably ascertainable useful life generally are subject to amortization over a so-called "safe harbor" 15-year period.[31] The safe harbor amortization period does not apply, however, to intangibles acquired from another person or to transaction expenditures relating to the restructuring or reorganization of a business entity or for acquisitions of capital.[32] The Proposed Regulations provide that the acquiror's costs to facilitate a taxable stock or asset acquisition are (subject to simplifying conventions) capitalized in the manner provided by current law.[33] Similarly, the target's costs in such an acquisition are treated in accordance with current law and either reduce the amount realized on an asset sale or are capitalized in connection with a stock sale. Comments were requested as to the proper application of the safe harbor amortization period to transaction costs incurred to facilitate acquisitions, including a number of issues in connection with tax-free and partially tax-free transactions. Inherent in these questions is the additional inquiry, about which comments also were requested, of whether such costs properly should create their own asset or should be allocated to some other asset.

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31 Prop. Treas. Reg. § 1.167(a)-3(b).

32 Prop. Treas. Reg. § 1.167(a)-3(b)(1)(ii) (acquired intangibles); Prop. Treas. Reg. § 1.167(a)-3(b)(2).

33 In a taxable asset acquisition, such amounts would be capitalized into the basis of the assets acquired, including goodwill and going concern value using the residual method of allocation, and recovered over the life of the assets. As a result of these rules, most acquisition costs that do not relate to a specific asset will be recovered over 15 years as part of the cost of amortizable Section 197 intangibles, so that no safe harbor amortization period is required.

We agree with the determination that the form of the transaction, i.e., stock acquisition or asset acquisition, should govern the recovery of transaction costs that are required to be capitalized. A substantial body of law has developed regarding the tax consequences of such transactions generally, and, as discussed above and in the preamble to the Proposed Regulations, the capitalization and recovery of transaction costs incurred in connection with them. Absent a compelling reason, we believe the existing body of law should not be disturbed. Continuing to distinguish the treatment of transaction costs based on the form of the transaction is consistent with the simplification goals of the Proposed Regulations. Further, such an approach should be relatively straightforward to administer because taxpayers and the IRS are accustomed to treating costs differently between these two forms; a different rule for each will not complicate the issue or create undue confusion.

2. Taxable Stock Acquisitions.

The Proposed Regulations provide that the acquiror's costs in a taxable stock acquisition are required to be capitalized into the basis of its stock, which would be recovered on any sale.[34] Target costs, on the other hand, are required to be capitalized into a separate intangible, to which the 15-year safe harbor amortization period does not apply, and for which no other recovery is provided except upon a liquidation.[35] The Treasury and the IRS sought comments regarding the treatment of these costs.

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[34] Prop. Treas. Reg. § 1.263(a)-4(e)(4) (requiring capitalization); Prop. Treas. Reg. § 1.263(a)-4(g) (basis rule).

[35] Id.; See also, e.g., Prop. Treas. Reg. § 1.263(a)-4(e)(7) Ex. 13 (requiring capitalization of certain fees paid by target); cf. INDOPCO, 503 U.S. at 84. We believe the authority referred to in Example 13 should be paragraph (b)(1)(iii), not paragraph (b)(1)(i), of the Proposed Regulation. See Prop. Treas. Reg. § 1.263(a)-4(e)(7) Exs. 15 & 16.

As described above, we believe that the treatment set out in the Proposed Regulations of costs incurred by the acquiror is appropriate. We question, however, whether recovery of transaction costs incurred by the Target in a stock transaction should be deferred until liquidation. We believe the better view would be to have the Target transaction costs represented as a non-amortizable asset deductible by Target upon either sale of target or liquidation of target. Such treatment would comport with the rationale for capitalization of those costs, that is, that the sale of the stock of the target creates a future benefit to the target, which benefit presumably has been fully realized by the time of the later stock sale. In addition, given the importance of the treatment of target costs, we recommend that whatever rules are determined to apply be prescribed separately and have examples illustrating their application.[36]

3. <u>Treatment of Expenses of Reorganizations</u>.

The Treasury and the IRS requested comments regarding the treatment of costs of acquisitions in which no gain is required to be recognized. In determining the treatment of such transaction costs, we believe that the Treasury and the IRS should look to the treatment of other cash expenditures in a reorganization. In particular, Section 362(b) provides that the basis of property acquired in a reorganization is equal to its basis in the hands of the transferor, increased by any gain recognized by the transferor on the transfer, and does not provide for any other adjustment based on the cash or other property transferred by the acquiror. We do not see a sufficient basis for distinguishing the rule applied to boot to provide a different result for transaction costs. Therefore, we recommend that neither the acquiror's nor the target's costs be

[36] We also suggest that Prop. Treas. Reg. § 1.263(a)-4(b)(1)(iii) be amended by adding "stock transfer" to the list of transactions included therein to make clear that the target's costs in a stock transfer are subject to capitalization.

capitalized into an asset for which recovery is permitted before liquidation.[37] Further, the allocation of basis derived from transaction costs incurred in an asset acquisition qualifying as a reorganization would present complexities not present in a taxable asset acquisition. In a taxable asset acquisition, it is relatively straightforward to allocate transaction costs among all of the assets purchased because under the residual method such costs will be allocated to goodwill if they are not allocated to the acquisition of a particular asset. In contrast, in the case of a non-taxable acquisition, it is not clear that the residual method is the appropriate model, because many acquired assets will have fair market values in excess of their tax bases as a result of the general carryover basis requirement. Although it would be possible to formulate a rule that would appropriately allocate such transaction costs, any such rule may well prove to be complicated and difficult to administer.

This result is consistent with the treatment of the expenses at issue in INDOPCO v. Commissioner. In that case, the Supreme Court held that transaction costs incurred by a target corporation in a reorganization transaction were not deductible under Section 162, and noted that capitalized expenditures for assets with no ascertainable useful life are recovered only on liquidation. The suggested regulation, if adopted, would confirm this result.[38] Further, this result appears consistent with Section 197(e)(8), which provides that fees for professional

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[37] In making this recommendation, we do not distinguish between reorganization transactions taking place in a Title 11 or similar proceeding and out-of-court reorganizations, nor do we believe that the costs subject to capitalization in a bankruptcy reorganization should be different from those subject to capitalization in an out-of-court transaction.

[38] We note that limited case law prior to INDOPCO permitted deduction of acquisition expenses incurred by an acquiring corporation in a tax-free reorganization upon the liquidation or sale of the acquired corporation. See, e.g., McCrory Corp. v. Commissioner, 651 F.2d 828 (1981). In light of INDOPCO and subsequent developments, however, we do not believe that such case law necessarily should control the regulations regarding transaction costs incurred in connection with tax-free reorganizations.

services and transaction costs incurred by parties to a transaction with respect to which any portion of the gain or loss is not recognized under part III of subchapter C (which includes reorganizations) are excluded from the definition of "Section 197 intangible," which would be eligible for 15-year amortization.[39]

4. Other Types of Capital Transactions.

Comments were requested regarding the application of the safe harbor amortization provision to transactions to which Section 351 or Section 355 apply. A number of different types of transactions, with varying objectives and requiring different types of transaction costs, can qualify for nonrecognition under Section 351. Such transactions can range from a sole proprietor contributing his or her business to a newly-formed corporation in exchange for stock of the corporation to a roll-up transaction in which one promoter organizes multiple simultaneous contributions to a single corporation in exchange for stock of the corporation to a transfer of stock that also qualifies as tax-free reorganization under Section 368(a)(1)(B) or 368(a)(2)(E). Notwithstanding the various forms that a transaction qualifying for nonrecognition under Section 351 can take, we believe that, given the substantial overlap between Section 351 transactions and reorganizations under Section 368, and the similar policy reasons for permitting nonrecognition in Section 351 and Section 368 transactions (i.e., such transactions do not reflect a sale of the enterprise, but rather a continued investment in a new form) transaction costs incurred to facilitate Section 351 transactions should be treated in the same manner as transaction costs incurred to facilitate reorganization transactions.

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[39] But cf. Martin D. Ginsburg & Jack S. Levin, Mergers, Acquisitions, and Buyouts ¶ 602.3 (Dec. 2002).

Similarly, a distribution pursuant to Section 355 also should be treated in the same manner as other reorganization transactions. Distributions of stock of a controlled corporation must be made to further a valid business purpose. Therefore, costs incurred to facilitate them properly are viewed as costs that enhance the value of the distributing corporation. In many cases it would be impractical to add such costs to the basis of the stock of the distributing corporation (e.g., a publicly traded corporation), and the distributing corporation's basis in the stock distributed is irrelevant following the distribution. To avoid such complications, we believe it would be appropriate for a distributing corporation to create a separate asset capitalizing such costs which, consistent with other costs of tax-free transactions discussed above, would be recovered only of the distributing corporation on liquidation.

5. Certain Acquisition Costs.

a. Success Fees.

As noted above, pursuant to the Proposed Regulations, an amount paid that is contingent on the successful closing of an acquisition is treated as inherently facilitative, and therefore required to be capitalized, except to the extent that evidence "clearly demonstrates" that some portion of the amount is allocable to activities that do not facilitate the acquisition.[40] In our view such fees should be treated as inherently facilitative and should be required to be capitalized. As discussed above, the scope of expenditures that are not inherently facilitative is relatively limited, essentially to expenditures for due diligence.

Although certain success-based fees, such as investment banker fees, may in part be paid for due diligence, or for other services that do not facilitate the particular transaction, to allow

[40] Prop. Treas. Reg. § 1.263(a)-4(e)(4)(i)(C).

allocation of success-based fees to non-facilitative and other activities merely invites controversy and decreases the simplification benefits that the Proposed Regulations are designed to achieve. If this rule is retained, we suggest that the standard of proof be clarified, e.g., preponderance of the evidence or by clear and convincing evidence that the expenditures were for items that were not inherently facilitative. The "clearly demonstrates" standard of the Proposed Regulations is unclear (and apparently not used in any other provision of the Code or the Regulations) and therefore itself is likely to foster controversy.

b. <u>Break-up Fees</u>.

The Proposed Regulations provide that an amount paid to terminate an existing agreement constitutes an amount paid to facilitate a transaction only if the second transaction is expressly conditioned on the termination of the existing agreement.[41] We are concerned that the requirement of an express condition in the contract might be subject to manipulation. We believe that if the second transaction is fundamentally inconsistent with the first transaction, *i.e.*, it is not possible to do both, then the break-up fee for the first transaction should be capitalized, regardless of whether the agreement's termination was expressly provided for in connection with the second transaction.

IV. <u>Other Comments</u>.

In addition to comments relating to the treatment of acquisition costs, the Treasury and the IRS requested comments on a number of discrete topics.

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[41] Prop. Treas. Reg. § 1.263(a)-4(e)(1)(ii).

A. Non-Cash Inducements.

In general, the Proposed Regulations require taxpayers to capitalize amounts paid to another party to induce that party to enter into, renew or renegotiate certain contracts. De minimis amounts of less than $5,000 that are paid for such purpose, however, are not required to be capitalized, although if the inducement exceeds $5,000 the full amount is required to be capitalized.[42] The Treasury and the IRS requested comments regarding whether in determining if a non-cash inducement is subject to immediate deduction as a de minimis amount, the inducement should be valued at its cost or its fair market value, as well as the treatment of any gain recognized on the transfer of the inducement.[43]

In general, when a taxpayer transfers appreciated property in satisfaction of an obligation, the taxpayer is required to recognize gain on the transfer in an amount equal to the difference between the fair market value and the adjusted tax basis of the property transferred.[44] Although we recognize that a transfer provided as an inducement to enter into a contract is not a transfer in satisfaction of a pre-existing legal obligation, we believe that the settled tax rules applying to transfers of appreciated property should apply to such transfers, so that the transferor would recognize gain or loss on the transfer.[45] Consistent with this treatment, the full fair market value of the inducement would be subject to deduction or capitalization. Also consistent with this rule,

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[42] Prop. Treas. Reg. § 1.263(a)-4(d)(5)(ii).

[43] The Proposed Regulations provide as an example of such an inducement the provision of a wireless phone in connection with entry into a wireless service contract. Prop. Treas. Reg. § 1.263(a)-4(d)(6) Ex. 4.

[44] See, e.g., Rev. Rul. 76-111, 1976-1 C.B. 214 (transfer of property in satisfaction of debt results in gain recognition); Rev. Rul. 69-181, 1969-1 C.B. 196 (transfer of assets of employer to employee as compensation results in gain recognition to employer).

[45] We would expect that in most cases the provision of an inducement would result in gain to the taxpayer.

we believe that a taxpayer should determine whether an inducement is subject to the de minimis rule based on its fair market value rather than its cost. We note that the greatest consequence of this rule would be in the case of inducements with a fair market value greater than $5,000 and a cost of less than $5,000, because provision of those inducements would not give rise to an immediate deduction if the fair market value rule were adopted. For inducements of lesser value, the only potential effect of the rule would be on character, in particular that the gain or loss on the transfer of the inducement could be capital and the expense would be ordinary.[46]

B. Amortization Safe Harbor.

The Proposed Regulations provide that amounts paid to acquire, produce or improve real property owned by a third party are required to be capitalized as the costs of an intangible asset.[47] Amounts that are required to be capitalized pursuant to this rule will be amortizable over the ascertainable useful life of the intangible or, if there is not such a life, over a 25-year period on a straight-line basis, in lieu of the shorter 15-year period applicable to other intangibles that lack ascertainable useful lives.[48] The preamble to the Proposed Regulations indicates that the 25-year period was chosen instead of a variable period based on the recovery period that would be applicable under Section 168 if the taxpayer owned the real property because of difficulties in determining the appropriate recovery period and the fact that certain property, such as raw land, may not be subject to depreciation pursuant to Section 168.

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46 Cf. Rev. Rul. 69-181, supra. If a taxpayer were required to recognize gain on the transfer of the inducement, but measured the de minimis nature of the transfer by reference to the cost of the inducement, it would be necessary to establish a rule to provide for the gain realized on the transfer of the inducement, which we believe would be an unnecessary complication, particularly in light of the relatively limited application of this rule.

47 Prop. Treas. Reg. § 1.263(a)-4(d)(8).

48 Prop. Treas. Reg. § 1.167(a)-3(b)(iv).

We believe that the Treasury and the IRS reached an appropriate compromise with respect to this issue. Although determining the appropriate recovery period for specific items of property is a regularly-occurring question, making and auditing the determination may be more difficult when the property is owned by a person other than the taxpayer, so that the taxpayer may not have all of the relevant facts available to it. In light of the overall simplification goals of the Proposed Regulations, we support the rejection of utilizing the recovery period of the asset as determined pursuant to Section 168. We agree that it is appropriate, in light of the relatively long recovery periods assigned to real property in Section 168,[49] to use a recovery period longer than 15 years for real property-related intangibles. The choice of 25 years, or some other period, we view as a policy choice to be made based on the desirability of facilitating the transactions in question and the cost to the fisc of the choice of a shorter recovery period.

C. Issues Relating to Transaction Costs.

The general rule that transaction costs paid to facilitate the acquisition, creation or enhancement of an intangible asset are subject to capitalization is subject to two "simplifying conventions" relating to employee compensation and de minimis costs. As discussed in the 2002 Report, we generally view both of those conventions as appropriate. Addressed below are two areas in which the IRS and the Treasury sought comment on the Proposed Regulations.

[49] See Section 168(c) (recovery period of residential real property is 27.5 years and of nonresidential real property is 39 years).

1. Employee Compensation.

a. Effect of Financial Reporting.

The Proposed Regulations provide that all employee compensation (including bonuses and commissions) is to be deductible currently.[50] In the Notice, the Treasury and the IRS suggested that certain compensation, such as bonuses, would be required to be capitalized, a suggestion that we supported on a limited basis in the 2002 Report. In the Proposed Regulations, the Treasury and the IRS have chosen not to require the capitalization of any amounts of bonuses for the stated reason that the allocation issues raised by such a rule, particularly tying annual and other periodic bonuses to individual transactions, would be too difficult to apply.

The Treasury and the IRS did, however, seek comment on the advisability of requiring the capitalization for tax purposes of compensation that is required to be capitalized for financial accounting purposes. Although we generally do not believe it is appropriate for methods of tax accounting to be controlled by those used for financial reporting, in the 2002 Report we noted that if financial accounting principles required that certain employee compensation costs be capitalized for financial reporting purposes, it would not be inappropriate for tax accounting to require the same costs to be capitalized. We indicated that this was particularly the case in light of the fact that the rationale for not requiring capitalization of such costs for tax purposes was that it was a rule of convenience and that a capitalization requirement would be unduly burdensome. If financial accounting already required such costs to be capitalized, the rationale for allowing an immediate deduction for tax purposes, assuming that tax accounting principles

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

would otherwise require capitalization, would be significantly weakened.[51] Accordingly, consistent with the 2002 Report, we recommend that the Treasury adopt a rule that requires employee compensation to be capitalized for income tax purposes if the costs are required to be capitalized for financial reporting purposes by the taxpayer. Any such capitalization should be limited to those costs required to be capitalized for financial accounting purposes and should require capitalization only to the extent required by financial accounting rules, in order to avoid imposing an additional burden on taxpayers for tax accounting. We make this recommendation notwithstanding the fact that a taxpayer that is not required to make financial reports to a third party or in regulatory filings, and therefore keeps books only in accordance with tax accounting principles, will not be affected by this rule, because we view the simplification rationale of the rule permitting the deduction to be one of administrative convenience.

b. Pre-Existing Obligations.

The Treasury and the IRS provide an example of the treatment of employee compensation in connection with a corporate acquisition.[52] In that example, employees of the target held compensatory options that, as a condition of the acquisition, were required to be terminated. The target paid its employees the spread between the current value of the stock and the strike price of the option. In the example, such amount is not required to be capitalized as a consequence of the employee compensation rule. It would be helpful if the example were clearer concerning the time of issuance of options. For example, if the intent is to permit deductibility in connection with options issued on the eve of an acquisition that should be made clear. Further, it

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[51] 2002 Report, supra, at n.66.

[52] Prop. Treas. Reg. § 1.263(a)-4(e)(7) Ex. 12.

would be helpful if the Final Regulations added the tax treatment of directors and independent contractors.

2. De Minimis Costs.

In general, under the Proposed Regulations a taxpayer is not required to capitalize costs of a transaction if, in the aggregate, the costs do not exceed $5,000.[53] For purposes of this rule, the term "transaction" includes all steps comprising the acquisition, creation or enhancement of an intangible asset, including all steps carried out as part of a single plan, and may involve more than one intangible asset, even if amounts paid in the transaction may be allocated to particular intangibles.[54] The de minimis rule does not apply to commissions, which, by example, is confirmed to mean commissions paid to non-employees.[55] We recommend that the Proposed Regulation providing the special rule for the treatment of commissions be limited by its terms to commissions paid to third parties. Although we understand that limitation to be implicit in the operation of the employee compensation rule, we believe an express statement would be useful.

The IRS and the Treasury sought comments as to whether the broad definition of the term "transaction" in conjunction with the examples provided in the Proposed Regulations would be sufficient to combat fragmentation of transaction expenses designed to qualify for immediate deduction by reason of the de minimis rule. We believe the definition of transaction sufficiently conveys the intended breadth, though clarifying that "transaction" encompasses all steps undertaken in connection with the acquisition, creation or enhancement of an intangible asset

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

[54] Prop. Treas. Reg. § 1.263(a)-4(e)(2) (definition of "transaction" for purposes of Proposed Regulation Section 1.263(a)-4)).

[55] Prop. Treas. Reg. §1.263(a)-4(e)(7) Ex. 7.

would be helpful. Use of the term "in connection with" would have the benefit of picking up the support of existing case law interpreting such term.[56]

We note that the only example in the Proposed Regulations that is intended to illustrate the term "transaction" relates to the treatment of a commission paid to a third party as part of an acquisition of multiple assets. Because such commissions are themselves subject to a special rule, we believe the example, while usefully illustrating that the multiple asset acquisition is a single transaction, is diluted by the discussion of the treatment of the commission.

D. Pools.

The Proposed Regulations provide for pooling of similar assets to determine (i) the applicability of the 12-month rule, (ii) whether de minimis transaction costs are incurred in connection with the creation of an intangible and (iii) whether de minimis inducements are provided to enter into a contract.[57] The Treasury and the IRS requested comments on a number of issues relating to pooling. In general, we view the pooling rules as likely providing a useful simplification measure for taxpayers who enter into a large number of similar contracts that may benefit from the 12-month or de minimis rules, because pooling will permit the taxpayers to make that determination on a group, rather than individual, basis. We believe that, in light of its simplification rationale, pooling should be required once it is elected absent the consent of the IRS to change to a non-pooling method. Taxpayers should not be permitted to elect pooling only in the years that it provides them with a benefit.

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[56] See, e.g., Snow v. Commissioner, 416 U.S. 500 (1974) (interpreting broadly the "in connection with [a] trade or business" requirement of Section 174).

[57] Prop. Treas. Reg. § 1.263(a)-4(d)(6)(ii) (inducements); -4(e)(3)(ii)(C) (expenditures); -4(f)(1)(iii) (12-month rule).

We recommend, however, in light of the highly detailed nature of pooling, that the final regulations provide that pooling will be permitted only to the extent provided in other published guidance, such as a Revenue Procedure. In that way, the IRS can issue industry-by-industry guidelines and have the flexibility to amend those guidelines and adopt new ones without a full rulemaking proceeding. If this approach were adopted, we urge the IRS to issue such a Revenue Procedure at the same time that the Proposed Regulations are finalized. We recommend that such Revenue Procedure include general rules applicable to any taxpayer for which specific rules are not provided by that Revenue Procedure or otherwise so that any taxpayer meeting the requirements of such rules could benefit from the pooling methods. We would expect that, over time, additional more specific rules would be issued so that the classes of taxpayers covered by the general rules would decline.