DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR LMSB AND SB/SE EMPLOYEES

FROM: Larry R. Langdon
Commissioner, Large and Mid-Size Business Division

Joseph G. Kehoe
Commissioner, Small Business/Self-Employed Division

SUBJECT: Guidelines for the Application of Advance Notice of Proposed Rulemaking for Intangibles Under IRC § 263(a)

Recently, there has been increased uncertainty and controversy in the capitalization area associated with expenditures that create or enhance intangible assets or benefits. This has caused a need for the Service to consider clarifying the application of IRC § 263(a).

As a first step in this process, on January 23, 2002, the Treasury Department and the Service released an Advance Notice of Proposed Rulemaking (ANPRM), addressing the capitalization of expenditures relating to intangibles. The ANPRM describes rules that are expected to be promulgated in proposed regulations, which will clarify the application of IRC § 263(a) to expenditures incurred in acquiring, creating, or enhancing certain intangible assets or benefits. The ANPRM solicits comments from the public regarding these proposals. All comments will be considered prior to the issuance of proposed regulations, which the Service is committed to providing by the end of 2002. You may access the ANPRM on Tax Notes Today at 2002 TNT 16-11.

The rules and standards in the ANPRM are not Service position and do not provide any authority for the concession of these issues. For example, administrative safe harbors and simplifying assumptions, such as the "de minimis rule" and the "regular and recurring rule" are merely proposals for possible inclusion in the expected proposed regulations; they are not standards to be utilized in resolving existing cases. Standard examination practices and procedures for resolution of capitalization issues should generally remain unchanged.

Examiners should note that the ANPRM applies only to capitalizing expenditures associated with intangibles under IRC § 263(a). Expenditures associated with tangible assets, or expenditures governed by other provisions of the law, e.g., IRC §§ 195, 263(g), 263(h), or 263A, are not impacted.

In addition, the treatment of transaction costs associated with the taxpayer's acquisition, creation, or enhancement of intangible assets or benefits has not changed. Those costs allocable to the transaction should continue to be treated as prescribed by existing law. See e.g. Rev. Rul. 99-23, 1999-1 C.B. 998. Post-acquisition integration costs that result from an acquisition and do provide substantial future benefits should also continue to be capitalized.

Further, examiners should be aware that the requirements respecting the adoption and change of accounting method pursuant to IRC § 446(e) continue to be applicable. If a taxpayer has adopted a method of accounting, the taxpayer may not change the method on an original tax return without first obtaining consent, nor may a taxpayer change a method of accounting by filing an amended tax return. See Rev. Rul. 90-38, 1990-1 C.B. 57.

Notwithstanding the above, it is recommended that examiners review Section B.1. of the ANPRM. Section B.1. states that the Treasury Department and the Service expect to propose a "12-month rule" for expenditures that create certain intangible rights or benefits. Under this rule, capitalization under § 263(a) would not be required unless the expenditure creates or enhances intangible rights or benefits that extend beyond the earlier of (i) 12 months after the first date on which the taxpayer realizes the rights or benefits attributable to the expenditure, or (ii) the end of the taxable year following the taxable year in which the expenditure is incurred. If adopted, this 12-month rule would be consistent with the recent decision in U.S. Freightways Corp. v. Commissioner, 270 F.3d 1137 (7th Cir. 2001), where the United States Court of Appeals for the Seventh Circuit recognized a "one-year rule" for purposes of allowing a deduction for prepaid license fees and insurance premiums.

While the ANPRM does not provide authority for present application of a 12-month rule, it is likely that Treasury and the Service will ultimately adopt such a rule in regulations. Given this likelihood, and considering the opinion in U.S. Freightways, we must consider whether it is an efficient utilization of our resources to propose capitalization of these expenditures, particularly in light of the relatively short tax deferral period (one taxable year) that results from the application of the 12-month rule. Accordingly, it is recommended that examiners utilize the following guidelines when determining whether to propose capitalization of certain short-term expenditures on examinations initiated prior to the release of the regulations:

1. For ongoing examinations in which the capitalization of the subject expenditures has resulted in the preparation of Form 5701, Notice of Proposed Adjustment (LMSB), or Form 4549, Revenue Agent's Report (SB/SE), the issue should be pursued.

2. For ongoing examinations in which Form 5701 or Form 4549 have not yet been prepared, the issue should not be pursued, in the absence of contrary guidance.

Questions relating to these issues can be directed to Sharon Russell, Capitalization Technical Advisor, at 216-328-2824 or Sharon.L.Russell@irs.gov. In addition, the ANPRM requests comments regarding various aspects of the rules and standards that are expected to be proposed. LMSB and SB/SE personnel are encouraged to provide their comments, particularly with respect to the administrability of the proposals and potential standards that would ease the burden associated with auditing these issues. Comments should be submitted by no later than March 15, 2002, to Sharon Russell for LMSB and to Linda Kroening (202-283-7661 or Linda.M.Kroening@irscounsel.treas.gov) for SB/SE. LMSB and SB/SE will consolidate all comments to be considered as a part of the process of drafting the proposed regulations.