INDOPCO: Dead Without a Wake?

by Robert W. Wood • San Francisco

It has long been clear that *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), was one of the thorns in the side of the corporate tax bar. Ever since *INDOPCO* was decided by the Supreme Court, it was clear that the IRS regarded the case as a boon. Conversely, taxpayers uniformly regarded it as a bust, though for some years, it was not clear just how broad the reach of *INDOPCO* would prove to be.

As *M&A Tax Report* readers well know, the Service's reading of *INDOPCO* turned out to be extraordinarily broad, extending to such areas as:

- environmental cleanup expenses [see Wood, "Environmental Remediation and Asbestos Removal (Part I)," Vol. 9, No. 3, *M&A Tax Report* (October 2000), p. 7; and (Part II) Vol. 9, No. 4, *M&A Tax Report* (November 2000), p. 5.);
- air traffic maintenance and repair expenses [see Chambers and Schiffhouer, "*INDOPCO* Takes Flight: The Capitalization of Aircraft Maintenance Costs (Part I)," Vol. 5, No. 5, *M&A Tax Report* (December 1996), p. 1; and (Part II) Vol. 5, No. 6, *M&A Tax Report* (January 1997), p. 1)];
- training costs [see Wood, "Are Training Costs Exempt from *INDOPCO*?" Vol. 5, No. 7, *M&A Tax Report* (February 1997), p. 1]; and
- employee salaries [see Muntean and Wood, "Tax Court Blows *INDOPCO* in *Norwest Corp. v. Commissioner*," Vol. 7, No. 10, *M&A Tax Report* (May 1999), p. 1].

Of course, there have been suggestions for some time now that the picture was changing. [See Muntean, "Third Circuit Puts Brakes on Service's Wild *INDOPCO* Driving," Vol. 8, No. 12, *M&A Tax Report* (July 2000), p. 6. See also Muntean, "Is the *INDOPCO* Cookie Beginning to Crumble?" Vol. 7, No. 2, *M&A Tax Report* (September 1998), p. 1]. When the Supreme Court was faced with the case in 1992, of course, it dealt only with takeover expenses, and then only in a limited context (*[hostile or friendly?)]*. Gradually, *INDOPCO* expanded to a host of other fields.

Indeed, it is difficult to ascribe only one metaphor to the growth of *INDOPCO*. A freight train running out of control? A glutinous giant, bloating ever fatter? A cancerous growth, cells multiplying exponentially? Well, you get the idea.

Enough is Enough

In a move that most *M&A Tax Report* readers have been applauding since Christmas, the U.S. Treasury Department has proposed regulations to provide a new framework for capitalization issues where expenditures are paid or incurred to acquire, create, or enhance intangible assets. Of course, all this hearkens back to the *INDOPCO* case, to the wave of decisions and commentary that followed it over the last 10 years, and more recently, to the preeminent *INDOPCO* Coalition and the IRS's notice of proposed rulemaking that debuted in January 2002.

"V" is for Victory!

Well, now we have proposed regulations: REG-125638-01, 67 Fed. Reg. No. 244, Dec. 19, 2002, p. 77701. It is difficult to summarize all of the good news that these proposed regulations contain. To cut to their most basic point—the separate and distinct asset test of *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971), has come back into favor. That is certainly good news.

Of course, these proposed regulations do require capitalization of certain amounts paid to acquire, create, or enhance intangibles. The proposed rules identify certain intangible assets that must be capitalized. Grouped into categories, the grouping is based on whether the intangibles are acquired from another party or created by the taxpayer (more about this important threshold determination later).

Rules are now provided for determining the extent to which taxpayers must also 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. A great undercurrent of the proposed rules is administrability and reducing compliance costs — in other words, administrative convenience. That is also good news.

Safe harbors are nearly always well received by tax practitioners and the business community. The safe harbors in these proposed rules are no exception, with proposed regulations under Section 167 providing a safe-harbor amortization period applying to certain created intangible assets that do not have readily ascertainable useful lives (and for which an amortization period is not otherwise prescribed).

New General Principles

Intangible assets are broadly defined, so a significant category of expenses is covered in these proposed rules. There is unlikely to be significant dispute about whether something is an intangible asset. There is likely to be a little confusion, though, over whether an intangible asset is "separate and distinct." Traditionally, the courts have evaluated this issue by considering whether the expenditure creates...

- a distinct and recognized property interest subject to protection under state or federal law;
- anything transferable or saleable; and
- anything with an ascertainable and measurable value in the money's worth.

[See *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971).]

Since we all have to live in the real world, the proposed regulations sensibly provide that one makes this determination as of the taxable year during which the amount is paid, not later, using the benefit of hindsight. While there may be disputes about whether something is a separate and distinct intangible asset, it is certainly true that making this determination does not have the same level of uncertainty as the determination whether something produces a significant future benefit.

Indeed, the preamble to the proposed regulations notes that the significant future-benefit standard resulted in a great deal of controversy. Ever since *INDOPCO*, significant future benefit has been an elusive concept. The IRS and Treasury Department now say the standard just doesn't provide enough certainty or clarity. Since clarity is one of the things the sound administration of tax laws requires, there is a good deal of rough justice meant to be accomplished here.

Still, there is a theme of future benefits underlying many of the categories that the Service intends to create. Indeed, the proposed regulations require the capitalization of nonlisted 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. For those who think *INDOPCO* has been obliterated (and there are some who say that it has), this warning should be viewed as evidence of the continued vitality of at least some of *INDOPCO*'s spirit.

Acquiring Intangibles From Another

The proposed regulations draw a fundamental distinction between intangibles that one acquires from someone else, and intangibles that one creates. When you purchase intangibles from someone else, of course, you must capitalize the purchase price, plus sales taxes and some transaction costs. The proposed regulations provide examples of intangibles that must be capitalized under this rule, if the intangible is acquired from another person. Many of the intangibles constitute amortizable Section 197 intangibles eligible for 15-year amortization.

Interestingly, the proposed rules do not address the treatment of transaction costs that the taxpayer may incur to facilitate the acquisition of the intangible. While capitalization is explicitly required for the amount paid to the other party to acquire the intangible, the various ancillary costs (attorneys' fees and brokerage commissions, for example), are not specifically addressed, at least not as part of this rule. Transaction costs are separately covered in another part of the proposed regulations.[see "Transaction Costs" below].

Creating Intangibles

Historically, taxpayers are far more likely to be confused about (and to litigate) the tax treatment of intangibles they create rather than those that they buy from someone else. The proposed regulations require taxpayers to capitalize amounts paid to another party to create or enhance with that party certain identified intangibles. There are a number of examples that help clarify these rules, and the identification of these various subcategories represent the guts of the new proposed regulations.

In a rule that is explicitly designed as a rule of administrative convenience (the IRS says it will reduce administrative and compliance costs), the proposed regulations adopt a 12-month rule for most created intangibles. Under it, a taxpayer is not required to capitalize amounts that provide benefits of a relatively brief duration.

We'll talk more about this 12-month concept below. Again, the related transactions costs are separately treated, so don't assume that the transaction costs are lumped together with the created intangibles. Transaction costs are separately covered (see "Transaction Costs" below).

Here is a hit list of the major categories of amounts paid to another party to create or enhance certain identified intangibles:

- **Financial Interests.** Taxpayers must capitalize amounts paid to another party to create or originate with that party certain financial interests. The financial interests include equity interests, such as those in corporations and partnerships, and financial instruments (i.e., debt, notional principal contracts, options). Significantly, the 12-month presumption does not apply here,—so amounts paid to create or enhance a financial interest aren't tested under the 12-month presumption.

- **Prepaid Expenses.** There is a raft of decisions covering prepaid expenses, which have historically been required to be capitalized. The proposed regulations continue this treatment. There was some confusion about whether prepayments for goods (as opposed to insurance, services, etc.) should be covered. The proposed regulations attempt to regulate this confusion by omitting any reference to goods.

- **Amounts Paid for Memberships and Privileges.** Taxpayers must capitalize amounts paid to an organization to obtain (or renew) a membership or privilege. Amounts paid to obtain a quality certification for the taxpayer's products, services, or business processes are not covered.

- **Amounts Paid to Obtain Rights from a Governmental Agency.** Payments to a governmental agency for trademark, trade name, copyright, license, permit, franchise, or other legal rights must be capitalized. This rule covers initial fees, but under the 12-month rule, taxpayers need not capitalize annual renewal fees paid to the agency.

- **Amounts Paid to Obtain or Modify Contract Rights.** Capitalization is required (though there is a *de minimus* threshold) paid to a another party to induce that party to enter into, renew, or renegotiate an agreement reducing certain rights. Some agreements produce contract rights that are reasonably certain to produce future benefits. Lease agreement or contracts to acquire or provide services would fall into this category. It's the same with covenants not to compete.

  However, amounts for personal services don't have the same effect as covenants not to compete, so amounts paid for services actually rendered are not covered. The *de minimum* exception is $5,000, so amounts that are $5,000 or less need not be capitalized, even though they are paid-for inducements.

- **Amounts Paid to Terminate Contracts.** The proposed regulations require taxpayers to capitalize amounts paid to terminate three types of contracts. First, termination payments enabling a taxpayer to reacquire a valuable right that he or she did not possess must be capitalized. Second, payments to terminate an agreement providing another party the exclusive right to acquire or use the taxpayer's property or services (or to conduct the taxpayer's business) must also be capitalized. Third, capitalization is required for payments to terminate an agreement prohibiting the taxpayer from competing with another, or from acquiring property (or services) from a competitor of another.

- **Amounts Paid to Acquire, Produce, or Improve Real Property Owned by Another.** Predictably, these expenditures must be capitalized, if the real property is reasonably expected to produce significant economic benefits for the taxpayer. A long line of cases and rulings require capitalization where the taxpayer provides property to another or improves property of another, expecting that the property will provide significant future benefits.[see, for example, *D. Loveman & Son Export Corp. v. Commissioner*, 34 T.C. 776 (1960); *aff'd*, 296 F.2d 732 (6th Cir. 1961)].

- **Amounts Paid to Defend or Perfect Title to Intangibles.** Here, capitalization is required, just as fighting about title to intangibles (or tangibles, for that matter), has always been required to be capitalized. Significantly, though, the proposed regulations indicate that this does not mean that capitalization of amounts paid to protect property against infringement and/or to recover profits and damages as a result of an infringement must be capitalized. In accordance with current law, those kinds of costs are generally deductible. [see *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954)].

Transaction Costs

As noted above, the proposed regulations do not lump transaction costs along with the underlying expense to which the transaction costs relate. Instead, there is a two-pronged rule regarding capitalization of transaction costs that facilitate the taxpayer's acquisition, creation, or enhancement of an intangible asset. The second prong of this rule requires capitalization of transaction costs that facilitate the taxpayer's restructuring or reorganization of a business entity, or that facilitate a transaction involving the acquisition of capital, including a stock issuance, loan, or recapitalization.

The first prong of this transaction-cost rule seems to be the most obvious. Capitalization is required, after all, not only for the cost of an asset itself, but for ancillary expenditures that are incurred in acquiring, creating, or enhancing the intangible. [see *Woodward v. Commissioner*, 397 U.S. 572 (1970)].

The second prong of the rule, though, can be a bit confusing. It recognizes that transaction costs that affect a change in the taxpayer's capital structure create betterments of a permanent or indefinite nature and therefore are appropriately capitalized. Here, the preamble to the proposed regulations cite *INDOPCO* (which, of course, involved professional fees), and a number of other cases involving costs to issue stock dividends, costs relating to a recapitalization, etc. Transaction costs that facilitate a stock issuance or recapitalization do not create a separate intangible asset, but instead offset the proceeds of the stock issuance. [see Revenue Ruling 69-330, 1969-1 C.B. 51. See *Affiliated Capital Corp. v. Commissioner*, 88 T.C. 1157 (1987)].

There has been a good deal of discussion about whether a reorganization is the kind of change of capital structure that requires capitalization. The proposed regulations, when using the term "reorganization" in this second prong of the transaction cost rule, contemplate a reorganization in a very broad sense (a change to an entity's capital structure), not merely a transaction qualifying as a tax-free reorganization under the Code.

Thus, it would include Section 351 transactions, bankruptcy reorganizations, etc. Yet, the preamble to the proposed regulations states that a reorganization and a restructuring do not include mere changes in an entity's business processes, commonly referred to as "re-engineering." For example, a taxpayer's change from a batch-inventory processing system to a just-in-time-inventory processing system, regardless of whether the taxpayer regards this as a "restructuring" or not, is not within the scope of the rule. Capitalization for such expense would not be required.

Facilitate What?

The proposed regulations provide a "facilitate" standard to determine whether transaction costs must be capitalized. It is intended to be narrower in scope than a "but for" standard. Thus, some transaction costs that are arguably capital under a "but for" standard (costs to downsize a workforce after a merger, or costs to integrate the operations of merged businesses) are not required to be capitalized under a facilitate standard.

These costs may not have been incurred but for the merger, but these costs do not facilitate the merger itself. An amount that facilitates a transaction, if it is incurred in the process of pursuing the acquisition, creation, or enhancement of an intangible asset (or in pursuing a restructuring, reorganization, or transaction involving the acquisition of capital), would need the facilitate standard and thus need to be capitalized.

Just when does all this start? When an acquisition is being investigated and pursued? Commentators have suggested that the rules should distinguish costs to facilitate the acquisition of a trade or business from costs to investigate the acquisition of a trade or business. Mere investigation, after all, is not an acquisition. Revenue Ruling 99-23, 1999-1 C.B. 1998, suggests that costs in determining whether to acquire a new trade or business are merely investigatory (not capital), while costs incurred to acquire a specific business are costs to facilitate the consummation of the acquisition.

Rather than adopting this Revenue Ruling 99-23 standard, the proposed regulations provide 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 stock or assets, and whether the taxpayer is the acquirer or the target), must be capitalized only if the amount is "inherently facilitative" or if the amount relates to activities performed after the earlier of the date of a letter of intent (or similar communication) is issued, or the date the taxpayer's board of directors approves the acquisition proposal.

Inherently Facilitative?

Okay, I admit that this concept seems a bit daft. Just what is this anyway? Amounts that are "inherently facilitative," include amounts relating to determining the value of the target, drafting transactional documents, or conveying property between the parties. Of course, an amount that does not facilitate the acquisition need not be capitalized. The IRS is apparently hopeful that this bright line rule will provide one administrable standard.

Interestingly, 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.

More Hostility

One of the early *INDOPCO* debates was whether a takeover was hostile or friendly, and just when a hostile takeover became friendly if the target admitted defeat at some point during the process. On the topic of transaction costs, the proposed regulations expressly state that transaction costs in defending against a hostile takeover do not facilitate an acquisition and therefore need not be capitalized. [see *A.E. Staley Manufacturing Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997)]. Initially, hostile acquisition attempts may become friendly, though, so that the proposed regulations take the now accepted bifurcation approach.

Who Is On First?

To be sure, there are many important portions of the landmark anti-*INDOPCO* proposed regulations (or whatever moniker you wish to give them). There is a lot to be covered, and a future issue of *The M&A Tax Report* will examine more of these important topics. Readers should note well, however, that the painfully loud (and echoing) *INDOPCO* mantra seems to be getting fainter and fainter!