

# Washington Tax Report

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## Updated Procedures Related to Final Regulations on Treatment of Costs to Acquire or Create Intangible Assets

In January 2004, the IRS issued final regulations under Section 263(a) of the Internal Revenue Code with respect to the tax treatment of costs to acquire or create intangible assets. Reg. Sec. 1.263(a)-4 contains rules requiring the capitalization of costs to acquire or create, and facilitate the acquisition or creation, of intangibles; Reg. Sec. 1.263(a)-5 address the capitalization of costs to facilitate an acquisition of a trade or business, a change in a business entity's capital structure, and certain other transactions. These regulations are effective for amounts paid or incurred in taxable years ending on or after December 31, 2003, with respect to taxpayers that change their method of accounting to comply with these regulations.

### Examples of Costs Not Required to be Capitalized

- Prepaid amount to obtain right or benefit of specified short-term duration (which in the case of accrual-method taxpayers will also have to satisfy the all-events test and "economic performance" requirement).
- Costs incurred to investigate an acquisition of a trade or business prior to a specified date.
- Employee compensation, even if functions relate to acquiring or creating intangibles.
- Costs to obtain certification of a taxpayer's product or business processes.
- Costs to develop a "package design" (as defined by the regulations).
- Lease termination fee by lessee if lease termination is not linked to obtaining a new lease.
- Amount paid of \$5,000 or less to obtain a contract for property or services.

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- Costs incurred to create or enhance a future benefit that is not identified in the regulations unless provided for under other sections of the Internal Revenue Code or future prospective guidance.

### Examples of Costs Required to be Capitalized

- Prepaid amounts to obtain right or benefit of greater than specified short-term duration.
- Costs incurred to “facilitate” (as defined by the regulations) an acquisition of a trade or business.
- Amounts paid to create or enhance a “separate and distinct intangible asset” as defined by the regulations.
- Costs in excess of \$5,000 to obtain a contract for property or services.
- Legal costs to facilitate acquisition or creation of intangible assets.
- Costs incurred to obtain rights from a government agency.
- Costs to defend title to intangible property.

### Procedures for Changing Current Methods of Accounting

Taxpayers having previously adopted a method of accounting inconsistent with these regulations should change their method to conform to these regulations. Generally, accounting method changes are made by obtaining the prior consent of the IRS, which requires submitting an application for change (Form 3115) to the IRS National Office in Washington, DC. However, these Section 263(a) regulations provide that taxpayers are granted automatic consent to change their method of accounting if they make the change beginning with their first or second taxable year ending on or after December 31, 2003. Revenue Procedure 2006-12 extended automatic consent to change an accounting method to comply with these regulations for any taxable year ending on or after December 31, 2005. Accordingly, if a taxpayer did not change its accounting method of a particular item or items of cost covered by these regulations beginning with the first or second taxable year ending on or after December 31, 2003, it can make the change automatically for any taxable year ending on or after December 31, 2005. Pursuant to IRS procedures, automatic consent is obtained by filing the

application with a timely-filed (including extensions) income tax return for the taxable year of change and a copy to the IRS National Office. Under these regulations, taxpayer-favorable negative Section 481(a) adjustments (to prevent the omission of deductions as in the case of costs previously capitalized and now permitted to be expensed) and taxpayer-unfavorable positive Section 481(a) adjustments (to prevent the duplication of deductions as in the case of costs previously deducted and now required to be capitalized) are made by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002. Pursuant to IRS procedures, negative adjustments are deducted from taxable income entirely in the year of change and positive adjustments are added to taxable income over a four-year period beginning with the year of the accounting method change.

### Example

X Corporation, an accrual method calendar year taxpayer, pays each year in August the annual premium for property insurance having a one-year term that begins September 1 of that year. Prior to these regulations, X Corporation had properly deducted on its calendar year tax return 8 months of the premium paid in August of the prior year and 4 months of the premium paid in August of the current year. Under these regulations, if X Corporation changes its accounting method, it will be able to deduct the full amount of the premium paid in August of the current year because the right or benefit attributable to the payment does not extend more than 12 months beyond the first date the benefit is realized and the economic performance requirements for deduction of an insurance premium by an accrual method taxpayer is satisfied upon payment.

X Corporation has not previously changed its method of accounting for its property insurance premium to comply with these regulations. However, pursuant to Rev. Proc. 2006-12, X Corporation can change its accounting method beginning with its 2007 year by filing Form 3115 with its timely-filed 2007 return. Accordingly, in addition to deducting in 2007 the full amount of the premium paid in August, X Corporation will include as a negative Section 481(a) adjustment fully deductible

in 2007 the 8 months of the premium paid in August 2006, attributable to 2007. **Note:** in the case of an insurance premium, the economic performance requirement is satisfied upon payment.

### New Procedures for Changes in Method Utilizing the Economic Performance 3½ Month Rule or Recurring Item Exception

Under Rev. Proc. 2005-9 and Rev. Proc. 2004-23 (the procedural guidance that predated Rev. Proc. 2006-12), taxpayers had the ability to file one method change under the automatic consent procedure to change to a method of utilizing the economic performance 3½ month rule of Reg. Sec. 1.461-4(d)(6)(ii) or the recurring item exception of Reg. Sec. 1.461-5 in conjunction with a change to a method of accounting to comply with the Section 263(a) regulations. Under Rev. Proc. 2006-12, however, a taxpayer who desired a change in method of accounting utilizing the 3½ month rule or the recurring item exception in conjunction with a change to a method provided by the final Section 263(a) regulations, was required to file separate method changes (1) a non-automatic method change under Rev. Proc. 97-27 to change a method of accounting to utilize the 3½ month rule or the recurring item exception, and (2) an automatic method change under Rev. Proc. 2006-12 to comply with the final Section 263(a) regulations. In response to numerous comments from taxpayers and practitioners, the IRS modified Rev. Proc. 2006-12 by issuing Rev. Proc. 2006-37, which now provides that a taxpayer that seeks to change its method of accounting to utilize the 3½ month rule or recurring item exception for the item for which the taxpayer also seeks a change to a method provided in the final regulations may apply for both changes for the same item on a single Form 3115 filed under the non-automatic procedures of Rev. Proc. 97-27. Thus, for example, a taxpayer is permitted to file a single non-automatic method change to accelerate a deduction for prepaid services or property by utilizing the 3½ month rule or recurring item exception and to comply with the 12-month rule for prepaid expenses under the final Section 263(a) regulations.