

Washington Tax Report

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Final Regulations on Treatment of Costs to Acquire or Create Intangible Assets

Introduction

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; and 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.

Set forth below are a few examples of costs that under these final regulations (i) are not required to be capitalized and (ii) are required to be capitalized. Please note that these are non-exclusive examples, as the regulations comprise approximately 50 pages of letter-size text with 87 regulatory examples of how its intricate rules apply to various factual situations. Also summarized below are the procedures for obtaining IRS consent to change an accounting method for taxpayers currently using a method that is inconsistent with these regulations, including an automatic consent procedure for accounting method changes that are made beginning with the first or second taxable year ending on or after December 31, 2003.

Examples of Costs Not Required to be Capitalized

- 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.
- Prepaid amount (which may have to satisfy "economic performance" requirement) to obtain right or benefit of specified short-term duration.
- Employee compensation, even if functions relate to acquiring or creating intangibles.
- Costs incurred to investigate an acquisition of a trade or business prior to a specified date.
- 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

- Costs in excess of \$5,000 to obtain a contract for property or services.
- Costs incurred to obtain rights from a government agency.
- Costs to defend title to intangible property.
- Legal costs to facilitate acquisition or creation of intangible assets.
- Prepaid amounts to obtain right or benefit of greater than specified short-term duration (or that do not satisfy the "economic performance" requirement, if applicable).
- Amounts paid to create or enhance a "separate and distinct intangible asset" as defined by the regulations.
- Costs incurred to "facilitate" (as defined by the regulations) an acquisition of a trade or business.

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. Accounting method changes are made by obtaining the prior consent of the IRS, which generally 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 taxable year ending on or after December 31, 2003. Revenue Procedure 2005-9 extended automatic consent to change an accounting method to comply with these regulations to the second taxable year ending on or after December 31, 2003. Accordingly, if a taxpayer did not change its accounting method for a particular item or items of

cost covered by these regulations beginning with its first taxable year ending on or after December 31, 2003, it can make the change automatically beginning with its second taxable year ending on or after December 31, 2003. 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. Under these regulations, positive adjustments (to prevent the duplication of deductions as in the case of costs previously deducted and now required to be capitalized) and negative adjustments (to prevent the omission of deductions as in the case of costs previously capitalized and now permitted to be expensed) 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, positive adjustments are added to taxable income over a four-year period beginning with the year of accounting method change and negative adjustments are deducted from taxable income in the year of 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 requirement for deduction of an insurance premium by an accrual method taxpayer is satisfied upon payment.

X Corporation did not change its method of accounting for its property insurance premium to comply with these regulations for its 2003 calendar year. However, pursuant to Rev. Proc. 2005-9, X Corporation can change its accounting method beginning with its 2004 year by filing Form 3115 with its timely-filed 2004 return. Accordingly, in addition to deducting in 2004 the full amount of the premium paid in August, X Corporation will include as a negative adjustment fully deductible in 2004 the 8 months of the premium paid in August, 2003, attributable to 2004.

Note: If a taxpayer changed its method of accounting to comply with the Section 263(a) regulations for an item or items of cost beginning with its first taxable year ending on or after December 31, 2003, the taxpayer may change its method of accounting to comply with the Section 263(a) regulations for a different item or items of cost beginning with its second taxable year ending on or after December 31, 2003.