

## Capitalization of certain costs with respect to intangibles

The following outlines important IRS regulations requiring the capitalization of certain costs (i.e. requiring a ratable deduction of the amount of the costs over the life of the asset, rather than a current expense deduction for the entire cost) related to acquiring or creating intangible assets or benefits, and certain costs that "facilitate" the acquisition or creation of intangibles. IRS generally defines the term "amount paid to facilitate" as an amount paid in the process of investigating or pursuing a transaction, based on all the relevant facts and circumstances. However, the rules as to whether costs facilitate acquisition or creation of an intangible asset under the regs are complex. Many costs must be capitalized where, for tax years beginning before Jan. 1, 2004, they could be deducted as current year expenses. These rules, found in the IRS regulations, can affect any type of business, and many ordinary business transactions.

The term "intangibles" covers a broad range of items. It may not always be simple to determine whether an intangible asset or benefit has been acquired or created. Some examples of intangibles are debt instruments, prepaid expenses, options, forward or futures contracts, foreign currency contracts, financial derivatives, leases, licenses, memberships, patents, copyrights, franchises, trademarks, tradenames, goodwill, annuity contracts, insurance contracts, endowment contracts, customer lists, ownership interests in any type of business entity (including corporations, partnerships, limited liability companies (LLCs), trusts and estates) and other rights, assets and agreements.

Once you determine you have acquired or created intangible property, it is necessary to examine the related costs, which may have to be capitalized. A few examples of amounts paid to acquire or create intangibles that are subject to the capitalization rules are:

- amounts paid to obtain, renew, renegotiate or upgrade memberships in trade associations or professional organizations;
- amounts paid to obtain, renew, renegotiate or upgrade a business or professional license;
- amounts paid as a loan to another party (creation of a debt instrument);
- prepayment of a lease;
- amounts paid to modify certain contract rights (such as a lease agreement);
- amounts paid to terminate an agreement (such as a merger agreement, a covenant not to compete, or an exclusive distribution agreement); or
- amounts paid to defend or perfect title to intangible property (such as a patent).

In addition, if a new business is acquired, or an existing business experiences any type of change in ownership or capital structure, such as a change resulting from reorganizations, restructurings, stock issuances, asset acquisitions or writing of options, costs that facilitate these acquisitions or ownership changes must be capitalized. You should be aware that the capitalization rules may apply if you are involved in acquisitions or ownership changes like the ones above. Please call to discuss the proper tax treatment of any costs related to these acquisitions or ownership changes.

Some examples of costs that facilitate acquisition or creation of an intangible are:

- payments to outside counsel to create a lease agreement;
- payments to accountants and appraisers to establish the value of a corporation's stock in a buyout of a minority shareholder;
- payments to outside consultants to investigate an agreement;
- investment banking fees connected with an initial public offering; and

amounts paid to outside counsel in a bankruptcy reorganization.

Like most rules, the above capitalization rules have exceptions. There are also certain elections taxpayers can make to capitalize items that are not ordinarily required to be capitalized. The above examples are not all-inclusive, and given the length and complexity of the regs, any transaction involving an intangible item and related costs should be analyzed to determine the tax consequences.