The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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FINAL REGULATIONS REGARDING CAPITALIZATION OF INTANGIBLE ASSETS

[16924] December 30, 2003 TO: TAX MEMBERS No. 68-03 ACCOUNTING/TREASURERS MEMBERS No. 63-03 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 19-03 RE: FINAL REGULATIONS REGARDING CAPITALIZATION OF INTANGIBLE ASSETS We are pleased to inform you that the Treasury Department and the Internal Revenue Service have finalized regulations1 under Internal Revenue Code section 263 regarding the deductibility or capitalization of amounts paid to acquire or create intangible assets. These regulations reflect numerous Institute suggestions,2 discussed below, to regulations proposed in 2002.3 In general, these regulations are effective as of the date of filing with the Federal Register, which is expected to occur by December 31, 2003. The final regulations include several significant, broad changes that resolve technical issues raised by the Institute. The final regulations eliminate the need to capitalize amounts paid to "enhance" intangible assets acquired or created by the taxpayer and also eliminate the broad potential ambiguity identified by the Institute in the proposed regulations. Moreover, the preamble to the regulations states that if an amount paid to acquire or create an intangible asset is not required to be capitalized under the final regulations or by another provision of the Code or regulations thereunder, or in subsequent published guidance, the IRS will not argue that the clear reflection of income requirement of Code section 446(b) and the regulations thereunder necessitates capitalization. It should also be noted that the final regulations include a new section of the regulations, Treas. Reg. 1.263(a)-5, which includes provisions (formerly included within 1.263(a)-4) related to amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. 1 The final regulations are available at http://www.treas.gov/press/releases/reports/regs.pdf. 2 See, Institute Memoranda to Accounting/Treasurers Members No. 16-03, Adviser Distributor Tax Issues Task Force No. 6-03, and Tax Members No. 18-03, dated March 19, 2003 [No. 15761]; and to Accounting/Treasurers Members No. 37-03, Adviser Distributor Tax Issues Task Force No. 18-03, and Tax Members No. 47-03, dated September 2, 2003 [No. 16480]. 3 See, Institute Memorandum to Accounting/Treasurers Members No. 53-02 and Tax Members No. 53-02, dated December 19, 2002 [No. 15475]. 2 Expansion of Simplifying Assumption for Employee Costs to Include Certain Director Fees and Contract Employee Expenses The final regulations retain the simplifying assumptions generally permitting deductions for employee compensation, overhead and de minimis costs. As requested by the Institute, the simplifying convention for employee expenses has been expanded to include as an employee expense a director's annual compensation.4 The final regulations also expand employee compensation treatment to payments to contract employees who perform "secretarial, clerical, or similar administrative support services" (excluding services related to the "preparation and distribution of proxy solicitations and other documents seeking

shareholder approval” for certain transactions). In addition, for corporations filing a consolidated return, payments by one corporation to another for services performed by an employee of the second corporation at a time when both corporations are members of the affiliated group are treated as employee compensation. Distributor Commissions As urged by the Institute, the final regulations clarify that commissions paid by a distributor to a broker pursuant to a distribution agreement covered by Rule 12b-1 are not required to be capitalized. See Treas. Reg. 1.263(a)-(4)(l), Example 11. In this example, neither the distributor’s cost of creating the distribution agreement nor the cost to the distributor of the broker commissions for the sale of regulated investment company (“RIC”) shares must be capitalized. Fund Start-Up Expenses Under the final regulations, a taxpayer must capitalize amounts incurred “in the process of investigating or otherwise pursuing” the acquisition or creation of an intangible. An agreement providing the taxpayer with the right to provide services is generally considered an intangible asset under the regulations, which would require capitalization of costs attributable to pursuing an advisory contract with a new fund (unless the costs were deductible under another provision of the regulations, such as the simplifying convention for employee compensation). However, the final regulations state that a contract will not be considered to be an agreement to provide services for purposes for the regulations if the other party has the right to terminate the agreement within the period prescribed by Treas. Reg. 1.263(a)-4(f)(1) (the “12- month rule”), and there is no economic compulsion against terminating the agreement within that period. Moreover, the final regulations also provide that amounts paid to facilitate the creation or renewal of an agreement with another that produces benefits for the taxpayer are not required to be capitalized as amounts that facilitate the creation of a separate and distinct intangible asset. Thus, if an advisory contract allowed a fund to terminate the contract at will with 60 days notice, then it appears no start-up expenses would be required to be capitalized. This 4 Amounts paid to a director for attendance at a special meeting of the board of directors (or a committee thereof) is not considered employee compensation for purposes of the simplifying convention, but may still be deductible depending on the circumstances. 3 result is reflected in the distributor commission example, discussed above, where the regulations note that distributor contracts are rarely terminated, but there is no economic compulsion to continue the agreement, and therefore the fact that the distributor contract can be terminated on 60 days notice means that the distributor need not capitalize the costs associated with creating the distribution agreement. Open-End RIC Stock Issuance and Redemption Costs The final regulations, like the proposed regulations, expressly provide that open-end RICs may deduct stock issuance costs (other than those related to the initial stock offering). Also, as requested by the Institute, the final regulations confirm that stock redemption costs paid by an open-end RIC are deductible. Defense of Business Reputation -- “Fund Bailouts” The final regulations retain an example from the proposed regulations with respect to “fund bailout” payments made by an investment adviser in defense of its business reputation. Example 6 of Treas. Reg. 1.263(a)-4(l) provides that when an investment adviser contributes cash to a money market fund to prevent the fund’s net asset value from sinking below $1.00 per share, the contribution may be deducted because it does not create an intangible asset. The example states that the benefit derived by this payment to protect business reputation is not an intangible asset for which capitalization is required. Payments that Enhance Intangible Assets As noted above, the final regulations do not require taxpayers to capitalize amounts paid to “enhance” intangible assets that are acquired or created by the taxpayer. However, taxpayers are required to capitalize amounts paid to enhance a separate and distinct intangible asset and amounts paid to enhance a future benefit identified by the Service in published guidance. However, in considering the potential impact of the “separate and distinct asset” test on fund complexes, it should be noted that the final regulations contain a new provision

explicitly stating that “[a]mounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset . . . regardless of whether the amounts results in the creation of an income stream under the agreement.” Treas. Reg. 1.263(a)-4(b)(3)(iii). Payments with Respect to an Ongoing Business Relationship As requested by the Institute, the final regulations clarify the treatment of amounts paid in expectation of an ongoing business relationship. The final regulations provide that a payment is not considered an amount paid to create, originate, enter into, renew or renegotiate an agreement with another party “if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and [the payment] is not contingent on the origination, renewal or renegotiation of an agreement with that party.” Change in Accounting Method Special rules also are provided for those taxpayers seeking to change a method of accounting to comply with the final regulations. For the taxpayer’s first taxable year ending on 4 or after the date that the final regulations are filed with the Federal Register, the taxpayer is granted the consent of the Commissioner to change its accounting method under the procedures that apply for an automatic consent to change accounting method. Treas. Reg. 1.446-1(e)(3)(ii). With the exception of a change to a pooling method (as authorized in the final regulations), a change in accounting method adjustment under section 481(a) will be determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002 (the date of the publication of the Advance Notice of Proposed Rulemaking5 related to capitalization guidance). Catherine Barré David Orlin Associate Counsel Assistant Counsel 5 See, Institute Memoranda to Tax Members No. 5-02 [No. 14400], dated January 25, 2002; and to Advisor Distributor Tax Issues Task Force [No. 14401], dated January 25, 2002.
