

the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.

(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar. 30, 1987]

§ 1.263(a)-3 Election to deduct or capitalize certain expenditures.

(a) Under certain provisions of the Code, taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(b) The sections referred to in paragraph (a) of this section include:

(1) Section 173 (circulation expenditures).

(2) Section 174 (research and experimental expenditures).

(3) Section 175 (soil and water conservation expenditures).

(4) Section 177 (trademark and trade name expenditures).

(5) Section 179 (election to expense certain depreciable business assets).

(6) Section 180 (expenditures by farmers for fertilizer, lime, etc.).

(7) Section 182 (expenditures by farmers for clearing land).

(8) Section 248 (organizational expenditures of a corporation).

(9) Section 266 (carrying charges).

(10) Section 615 (exploration expenditures).

(11) Section 616 (development expenditures).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6794, 30 FR 792, Jan. 26, 1965; T.D. 8121, 52 FR 414, Jan. 6, 1987]

§ 1.263(a)-4 Amounts paid to acquire or create intangibles.

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire or create intangibles. Except to the extent provided in paragraph (d)(8) of this section, the rules provided by this section

do not apply to amounts paid to acquire or create tangible assets. Paragraph (b) of this section provides a general principle of capitalization. Paragraphs (c) and (d) of this section identify intangibles for which capitalization is specifically required under the general principle. Paragraph (e) of this section provides rules for determining the extent to which taxpayers must capitalize transaction costs. Paragraph (f) of this section provides a 12-month rule intended to simplify the application of the general principle to certain payments that create benefits of a brief duration. Additional rules and examples relating to these provisions are provided in paragraphs (g) through (n) of this section. The applicability date of the rules in this section is provided in paragraph (o) of this section. Paragraph (p) of this section provides rules applicable to changes in methods of accounting made to comply with this section.

(b) *Capitalization with respect to intangibles*—(1) *In general.* Except as otherwise provided in this section, a taxpayer must capitalize—

(i) An amount paid to acquire an intangible (see paragraph (c) of this section);

(ii) An amount paid to create an intangible described in paragraph (d) of this section;

(iii) An amount paid to create or enhance a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section;

(iv) An amount paid to create or enhance a future benefit identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter) as an intangible for which capitalization is required under this section; and

(v) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) an acquisition or creation of an intangible described in paragraph (b)(1)(i), (ii), (iii) or (iv) of this section.

(2) *Published guidance.* Any published guidance identifying a future benefit as an intangible for which capitalization is required under paragraph (b)(1)(iv) of this section applies only to amounts

paid on or after the date of publication of the guidance.

(3) *Separate and distinct intangible asset*—(i) *Definition*. The term *separate and distinct intangible asset* means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. In addition, for purposes of this section, a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer. The determination of whether a payment creates a separate and distinct intangible asset is made based on all of the facts and circumstances existing during the taxable year in which the payment is made.

(ii) *Creation or termination of contract rights*. Amounts paid to another party to create, originate, enter into, renew or renegotiate an agreement with that party that produces rights or benefits for the taxpayer (and amounts paid to facilitate the creation, origination, enhancement, renewal or renegotiation of such an agreement) are treated as amounts that do not create (or facilitate the creation of) a separate and distinct intangible asset within the meaning of this paragraph (b)(3). Further, amounts paid to another party to terminate (or facilitate the termination of) an agreement with that party are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). See paragraphs (d)(2), (d)(6), and (d)(7) of this section for rules that specifically require capitalization of amounts paid to create or terminate certain agreements.

(iii) *Amounts paid in performing services*. Amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3), regardless of whether the amounts result in the creation of an income stream under the agreement.

(iv) *Creation of computer software*. Except as otherwise provided in the Internal Revenue Code, the regulations thereunder, or other published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter), amounts paid to develop computer software are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3).

(v) *Creation of package design*. Amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). For purposes of this section, the term *package design* means the specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and other elements on a given product package, or the design of a container with respect to its shape or function.

(4) *Coordination with other provisions of the Internal Revenue Code*—(i) *In general*. Nothing in this section changes the treatment of an amount that is specifically provided for under any other provision of the Internal Revenue Code (other than section 162(a) or 212) or the regulations thereunder.

(ii) *Example*. The following example illustrates the rule of this paragraph (b)(4):

Example. On January 1, 2004, G enters into an interest rate swap agreement with unrelated counterparty H under which, for a term of five years, G is obligated to make annual payments at 11% and H is obligated to make annual payments at LIBOR on a notional principal amount of \$100 million. At the time G and H enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 2004, H pays G a yield adjustment fee of \$3,790,786. This yield adjustment fee constitutes an amount paid to create an intangible and would be capitalized under paragraph (d)(2) of this section. However, because the yield adjustment fee is a nonperiodic payment on a notional principal contract as defined in § 1.446-3(c), the treatment of this fee is governed by § 1.446-3 and not this section.

(c) *Acquired intangibles*—(1) *In general*. A taxpayer must capitalize amounts paid to another party to acquire any

intangible from that party in a purchase or similar transaction. Examples of intangibles within the scope of this paragraph (c) include, but are not limited to, the following (if acquired from another party in a purchase or similar transaction):

(i) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity.

(ii) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes.

(iii) A financial instrument, such as—

(A) A notional principal contract;

(B) A foreign currency contract;

(C) A futures contract;

(D) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property));

(E) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); and

(F) Any other financial derivative.

(iv) An endowment contract, annuity contract, or insurance contract.

(v) Non-functional currency.

(vi) A lease.

(vii) A patent or copyright.

(viii) A franchise, trademark or tradename (as defined in §1.197-2(b)(10)).

(ix) An assembled workforce (as defined in §1.197-2(b)(3)).

(x) Goodwill (as defined in §1.197-2(b)(1)) or going concern value (as defined in §1.197-2(b)(2)).

(xi) A customer list.

(xii) A servicing right (for example, a mortgage servicing right that is not treated for Federal income tax purposes as a stripped coupon).

(xiii) A customer-based intangible (as defined in §1.197-2(b)(6)) or supplier-based intangible (as defined in §1.197-2(b)(7)).

(xiv) Computer software.

(xv) An agreement providing either party the right to use, possess or sell an intangible described in paragraphs (c)(1)(i) through (v) of this section.

(2) *Readily available software.* An amount paid to obtain a nonexclusive license for software that is (or has been) readily available to the general public on similar terms and has not been substantially modified (within the meaning of §1.197-2(c)(4)) is treated for purposes of this paragraph (c) as an amount paid to another party to acquire an intangible from that party in a purchase or similar transaction.

(3) *Intangibles acquired from an employee.* Amounts paid to an employee to acquire an intangible from that employee are not required to be capitalized under this section if the amounts are includible in the employee's income in connection with the performance of services under section 61 or 83. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Debt instrument. X corporation, a commercial bank, purchases a portfolio of existing loans from Y corporation, another financial institution. X pays Y \$2,000,000 in exchange for the portfolio. The \$2,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation holds a call option entitling it to purchase from W all of the outstanding stock of X at a certain price per share. Z corporation acquires the call option from Y in exchange for \$5,000,000. The \$5,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 3. Ownership interest in a corporation. Same as *Example 2*, but assume Z exercises its option and purchases from W all of the outstanding stock of X in exchange for \$100,000,000. The \$100,000,000 paid to W constitutes an amount paid to acquire an intangible from W and must be capitalized.

Example 4. Customer list. N corporation, a retailer, sells its products through its catalog and mail order system. N purchases a customer list from R corporation. N pays R \$100,000 in exchange for the customer list. The \$100,000 paid to R constitutes an amount

paid to acquire an intangible from R and must be capitalized.

Example 5. Goodwill. Z corporation pays W corporation \$10,000,000 to purchase all of the assets of W in a transaction that constitutes an applicable asset acquisition under section 1060(c). Of the \$10,000,000 consideration paid in the transaction, \$9,000,000 is allocable to tangible assets purchased from W and \$1,000,000 is allocable to goodwill. The \$1,000,000 allocable to goodwill constitutes an amount paid to W to acquire an intangible from W and must be capitalized.

(d) *Created intangibles—(1) In general.* Except as provided in paragraph (f) of this section (relating to the 12-month rule), a taxpayer must capitalize amounts paid to create an intangible described in this paragraph (d). The determination of whether an amount is paid to create an intangible described in this paragraph (d) is to be made based on all of the facts and circumstances, disregarding distinctions between the labels used in this paragraph (d) to describe the intangible and the labels used by the taxpayer and other parties to the transaction.

(2) *Financial interests—(i) In general.* A taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the following financial interests, whether or not the interest is regularly traded on an established market:

(A) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity.

(B) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for Federal income tax purposes.

(C) A financial instrument, such as—

- (1) A letter of credit;
- (2) A credit card agreement;
- (3) A notional principal contract;
- (4) A foreign currency contract;
- (5) A futures contract;
- (6) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless

of whether the taxpayer provides or acquires the property)); and

(7) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); and

(β) Any other financial derivative.

(D) An endowment contract, annuity contract, or insurance contract that has or may have cash value.

(E) Non-functional currency.

(F) An agreement providing either party the right to use, possess or sell a financial interest described in this paragraph (d)(2).

(ii) *Amounts paid to create, originate, enter into, renew or renegotiate.* An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate a financial interest with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of a financial interest with that party.

(iii) *Renegotiate.* A taxpayer is treated as renegotiating a financial interest if the terms of the financial interest are modified. A taxpayer also is treated as renegotiating a financial interest if the taxpayer enters into a new financial interest with the same party (or substantially the same parties) to a terminated financial interest, the taxpayer could not cancel the terminated financial interest without the consent of the other party (or parties), and the other party (or parties) would not have consented to the cancellation unless the taxpayer entered into the new financial interest. A taxpayer is treated as unable to cancel a financial interest without the consent of the other party (or parties) if, under the terms of the financial interest, the taxpayer is subject to a termination penalty and the other party (or parties) to the financial interest modifies the terms of the penalty.

(iv) *Coordination with other provisions of this paragraph (d).* An amount described in this paragraph (d)(2) that is also described elsewhere in paragraph

(d) of this section is treated as described only in this paragraph (d)(2).

(v) *Coordination with §1.263(a)-5.* See §1.263(a)-5 for the treatment of borrowing costs and the treatment of amounts paid by an option writer.

(vi) *Examples.* The following examples illustrate the rules of this paragraph (d)(2):

Example 1. Loan. X corporation, a commercial bank, makes a loan to A in the principal amount of \$250,000. The \$250,000 principal amount of the loan paid to A constitutes an amount paid to another party to create a debt instrument with that party under paragraph (d)(2)(i)(B) of this section and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation pays W \$1,000,000 in exchange for W's grant of a 3-year call option to Y permitting Y to purchase all of the outstanding stock of X at a certain price per share. Y's payment of \$1,000,000 to W constitutes an amount paid to another party to create an option with that party under paragraph (d)(2)(i)(C)(7) of this section and must be capitalized.

Example 3. Partnership interest. Z corporation pays \$10,000 to P, a partnership, in exchange for an ownership interest in P. Z's payment of \$10,000 to P constitutes an amount paid to another party to create an ownership interest in a partnership with that party under paragraph (d)(2)(i)(A) of this section and must be capitalized.

Example 4. Take or pay contract. Q corporation, a producer of natural gas, pays \$1,000,000 to R during 2005 to induce R corporation to enter into a 5-year "take or pay" gas purchase contract. Under the contract, R is liable to pay for a specified minimum amount of gas, whether or not R takes such gas. Q's payment of \$1,000,000 is an amount paid to another party to induce that party to enter into an agreement providing Q the right and obligation to provide property or be compensated for such property (regardless of whether the property is provided) under paragraph (d)(2)(i)(C)(6) of this section and must be capitalized.

Example 5. Agreement to provide property. P corporation pays R corporation \$1,000,000 in exchange for R's agreement to purchase 1,000 units of P's product at any time within the three succeeding calendar years. The agreement describes P's \$1,000,000 as a sales discount. P's \$1,000,000 payment is an amount paid to induce R to enter into an agreement providing P the right and obligation to provide property under paragraph (d)(2)(i)(C)(6) of this section and must be capitalized.

Example 6. Customer incentive payment. S corporation, a computer manufacturer, seeks to develop a business relationship with V

corporation, a computer retailer. As an incentive to encourage V to purchase computers from S, S enters into an agreement with V under which S agrees that, if V purchases \$20,000,000 of computers from S within 3 years from the date of the agreement, S will pay V \$2,000,000 on the date that V reaches the \$20,000,000 threshold. V reaches the \$20,000,000 threshold during the third year of the agreement, and S pays V \$2,000,000. S is not required to capitalize its payment to V under this paragraph (d)(2) because the payment does not provide S the right or obligation to provide property and does not create a separate and distinct intangible asset for S within the meaning of paragraph (b)(3)(i) of this section.

(3) *Prepaid expenses*—(i) *In general.* A taxpayer must capitalize prepaid expenses.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(3):

Example 1. Prepaid insurance. N corporation, an accrual method taxpayer, pays \$10,000 to an insurer to obtain three years of coverage under a property and casualty insurance policy. The \$10,000 is a prepaid expense and must be capitalized under this paragraph (d)(3). Paragraph (d)(2) of this section does not apply to the payment because the policy has no cash value.

Example 2. Prepaid rent. X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, X prepays \$240,000. No other amounts are due under the lease. The \$240,000 is a prepaid expense and must be capitalized under this paragraph (d)(3).

(4) *Certain memberships and privileges*—(i) *In general.* A taxpayer must capitalize amounts paid to an organization to obtain, renew, renegotiate, or upgrade a membership or privilege from that organization. A taxpayer is not required to capitalize under this paragraph (d)(4) an amount paid to obtain, renew, renegotiate or upgrade certification of the taxpayer's products, services, or business processes.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(4):

Example 1. Hospital privilege. B, a physician, pays \$10,000 to Y corporation to obtain lifetime staff privileges at a hospital operated by Y. B must capitalize the \$10,000 payment under this paragraph (d)(4).

Example 2. Initiation fee. X corporation pays a \$50,000 initiation fee to obtain membership in a trade association. X must capitalize the \$50,000 payment under this paragraph (d)(4).

Example 3. Product rating. V corporation, an automobile manufacturer, pays W corporation, a national quality ratings association, \$100,000 to conduct a study and provide a rating of the quality and safety of a line of V's automobiles. V's payment is an amount paid to obtain a certification of V's product and is not required to be capitalized under this paragraph (d)(4).

Example 4. Business process certification. Z corporation, a manufacturer, seeks to obtain a certification that its quality control standards meet a series of international standards known as ISO 9000. Z pays \$50,000 to an independent registrar to obtain a certification from the registrar that Z's quality management system conforms to the ISO 9000 standard. Z's payment is an amount paid to obtain a certification of Z's business processes and is not required to be capitalized under this paragraph (d)(4).

(5) *Certain rights obtained from a governmental agency—(i) In general.* A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(5):

Example 1. Business license. X corporation pays \$15,000 to state Y to obtain a business license that is valid indefinitely. Under this paragraph (d)(5), the amount paid to state Y is an amount paid to a government agency for a right granted by that agency. Accordingly, X must capitalize the \$15,000 payment.

Example 2. Bar admission. A, an individual, pays \$1,000 to an agency of state Z to obtain a license to practice law in state Z that is valid indefinitely, provided A adheres to the requirements governing the practice of law in state Z. Under this paragraph (d)(5), the amount paid to state Z is an amount paid to a government agency for a right granted by that agency. Accordingly, A must capitalize the \$1,000 payment.

(6) *Certain contract rights—(i) In general.* Except as otherwise provided in this paragraph (d)(6), a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party—

(A) An agreement providing the taxpayer the right to use tangible or intangible property or the right to be compensated for the use of tangible or intangible property;

(B) An agreement providing the taxpayer the right to provide or to receive services (or the right to be compensated for services regardless of whether the taxpayer provides such services);

(C) A covenant not to compete or an agreement having substantially the same effect as a covenant not to compete (except, in the case of an agreement that requires the performance of services, to the extent that the amount represents reasonable compensation for services actually rendered);

(D) An agreement not to acquire additional ownership interests in the taxpayer; or

(E) An agreement providing the taxpayer (as the covered party) with an annuity, an endowment, or insurance coverage.

(ii) *Amounts paid to create, originate, enter into, renew or renegotiate.* An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate an agreement with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of an agreement with that party.

(iii) *Renegotiate.* A taxpayer is treated as renegotiating an agreement if the terms of the agreement are modified. A taxpayer also is treated as renegotiating an agreement if the taxpayer enters into a new agreement with the same party (or substantially the same parties) to a terminated agreement, the taxpayer could not cancel the terminated agreement without the consent of the other party (or parties), and the other party (or parties) would not have consented to the cancellation unless the taxpayer entered into the new agreement. A taxpayer is treated as unable to cancel an agreement without the consent of the other party (or parties) if, under the terms of the agreement, the taxpayer is subject to a termination penalty and the other party (or parties) to the agreement modifies the terms of the penalty.

(iv) *Right.* An agreement does not provide the taxpayer a right to use

property or to provide or receive services if the agreement may be terminated at will by the other party (or parties) to the agreement before the end of the period prescribed by paragraph (f)(1) of this section. An agreement is not terminable at will if the other party (or parties) to the agreement is economically compelled not to terminate the agreement until the end of the period prescribed by paragraph (f)(1) of this section. All of the facts and circumstances will be considered in determining whether the other party (or parties) to an agreement is economically compelled not to terminate the agreement. An agreement also does not provide the taxpayer the right to provide services if the agreement merely provides that the taxpayer will stand ready to provide services if requested, but places no obligation on another person to request or pay for the taxpayer's services.

(v) *De minimis amounts.* A taxpayer is not required to capitalize amounts paid to another party (or parties) to create, originate, enter into, renew or renegotiate with that party (or those parties) an agreement described in paragraph (d)(6)(i) of this section if the aggregate of all amounts paid to that party (or those parties) with respect to the agreement does not exceed \$5,000. If the aggregate of all amounts paid to the other party (or parties) with respect to that agreement exceeds \$5,000, then all amounts must be capitalized. For purposes of this paragraph (d)(6), an amount paid in the form of property is valued at its fair market value at the time of the payment. In general, a taxpayer must determine whether the rules of this paragraph (d)(6)(v) apply by accounting for the specific amounts paid with respect to each agreement. However, a taxpayer that reasonably expects to create, originate, enter into, renew or renegotiate at least 25 similar agreements during the taxable year may establish a pool of agreements for purposes of determining the amounts paid with respect to the agreements in the pool. Under this pooling method, the amount paid with respect to each agreement included in the pool is equal to the average amount paid with respect to all agreements included in the pool. A taxpayer computes the average

amount paid with respect to all agreements included in the pool by dividing the sum of all amounts paid with respect to all agreements included in the pool by the number of agreements included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(vi) *Exception for lessee construction allowances.* Paragraph (d)(6)(i) of this section does not apply to amounts paid by a lessor to a lessee as a construction allowance to the extent the lessee expends the amount for the tangible property that is owned by the lessor for Federal income tax purposes (*see, for example, section 110*).

(vii) *Examples.* The following examples illustrate the rules of this paragraph (d)(6):

Example 1. New lease agreement. V seeks to lease commercial property in a prominent downtown location of city R. V pays Z, the owner of the commercial property, \$50,000 in exchange for Z entering into a 10-year lease with V. V's payment is an amount paid to another party to enter into an agreement providing V the right to use tangible property. Because the \$50,000 payment exceeds \$5,000, no portion of the amount paid to Z is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, V must capitalize the entire \$50,000 payment.

Example 2. Modification of lease agreement. Partnership Y leases a piece of equipment for use in its business from Z corporation. When the lease has a remaining term of 3 years, Y requests that Z modify the existing lease by extending the remaining term by 5 years. Y pays \$50,000 to Z in exchange for Z's agreement to modify the existing lease. Y's payment of \$50,000 is an amount paid to another party to renegotiate an agreement providing Y the right to use property. Because the \$50,000 payment exceeds \$5,000, no portion of the amount paid to Z is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, Y must capitalize the entire \$50,000 payment.

Example 3. Modification of lease agreement. In 2004, R enters into a 5-year, non-cancelable lease of a mainframe computer for use in its business. R subsequently determines that the mainframe computer that R is leasing is no longer adequate for its needs. In 2006, R and P corporation (the lessor) agree to terminate the 2004 lease and to enter into a new 5-year lease for a different and more powerful mainframe computer. R pays P a \$75,000 early termination fee. P would not have agreed to terminate the 2004 lease unless R agreed to enter into the 2006 lease. R's payment of \$75,000 is an amount

paid to another party to renegotiate an agreement providing R the right to use property. Because the \$75,000 payment exceeds \$5,000, no portion of the amount paid to P is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, R must capitalize the entire \$75,000 payment.

Example 4. Modification of lease agreement. Same as *Example 3*, except the 2004 lease agreement allows R to terminate the lease at any time subject to a \$75,000 early termination fee. Because R can terminate the lease without P's approval, R's payment of \$75,000 is not an amount paid to another party to renegotiate an agreement. Accordingly, R is not required to capitalize the \$75,000 payment under this paragraph (d)(6).

Example 5. Modification of lease agreement. Same as *Example 4*, except P agreed to reduce the early termination fee to \$60,000. Because R did not pay an amount to renegotiate the early termination fee, R's payment of \$60,000 is not an amount paid to another party to renegotiate an agreement. Accordingly, R is not required to capitalize the \$60,000 payment under this paragraph (d)(6).

Example 6. Covenant not to compete. R corporation enters into an agreement with A, an individual, that prohibits A from competing with R for a period of three years. To encourage A to enter into the agreement, R agrees to pay A \$100,000 upon the signing of the agreement. R's payment is an amount paid to another party to enter into a covenant not to compete. Because the \$100,000 payment exceeds \$5,000, no portion of the amount paid to A is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(C) of this section, R must capitalize the entire \$100,000 payment.

Example 7. Standstill agreement. During 2004 through 2005, X corporation acquires a large minority interest in the stock of Z corporation. To ensure that X does not take control of Z, Z pays X \$5,000,000 for a standstill agreement under which X agrees not to acquire any more stock in Z for a period of 10 years. Z's payment is an amount paid to another party to enter into an agreement not to acquire additional ownership interests in Z. Because the \$5,000,000 payment exceeds \$5,000, no portion of the amount paid to X is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(D) of this section, Z must capitalize the entire \$5,000,000 payment.

Example 8. Signing bonus. Employer B pays a \$25,000 signing bonus to employee C to induce C to come to work for B. C can leave B's employment at any time to work for a competitor of B and is not required to repay the \$25,000 bonus to B. Because C is not economically compelled to continue his employment with B, B's payment does not provide B the right to receive services from C. Accord-

ingly, B is not required to capitalize the \$25,000 payment.

Example 9. Renewal. In 2000, M corporation and N corporation enter into a 5-year agreement that gives M the right to manage N's investment portfolio. In 2005, N has the option of renewing the agreement for another three years. During 2004, M pays \$10,000 to send several employees of N to an investment seminar. M pays the \$10,000 to help develop and maintain its business relationship with N with the expectation that N will renew its agreement with M in 2005. Because M's payment is not contingent on N agreeing to renew the agreement, M's payment is not an amount paid to renew an agreement under paragraph (d)(6)(ii) of this section and is not required to be capitalized.

Example 10. De minimis payments. X corporation is engaged in the business of providing wireless telecommunications services to customers. To induce customer B to enter into a 3-year non-cancelable telecommunications contract, X provides B with a free wireless telephone. The fair market value of the wireless telephone is \$300 at the time it is provided to B. X's provision of a wireless telephone to B is an amount paid to B to induce B to enter into an agreement providing X the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Because the amount of the inducement is \$300, the amount of the inducement is *de minimis* under paragraph (d)(6)(v) of this section. Accordingly, X is not required to capitalize the amount of the inducement provided to B.

(7) *Certain contract terminations*—(i) *In general.* A taxpayer must capitalize amounts paid to another party to terminate—

(A) A lease of real or tangible personal property between the taxpayer (as lessor) and that party (as lessee);

(B) An agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business (other than an intangible described in paragraph (c)(1)(i) through (iv) of this section or a financial interest described in paragraph (d)(2) of this section); or

(C) An agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party.

(ii) *Certain break-up fees.* Paragraph (d)(7)(i) of this section does not apply to the termination of a transaction described in § 1.263(a)-5(a) (relating to an acquisition of a trade or business, a change in the capital structure of a

business entity, and certain other transactions). See §1.263(a)-5(c)(8) for rules governing the treatment of amounts paid to terminate a transaction to which that section applies.

(iii) *Examples.* The following examples illustrate the rules of this paragraph (d)(7):

Example 1. Termination of exclusive license agreement. On July 1, 2005, N enters into a license agreement with R corporation under which N grants R the exclusive right to manufacture and distribute goods using N's design and trademarks for a period of 10 years. On June 30, 2007, N pays R \$5,000,000 in exchange for R's agreement to terminate the exclusive license agreement. N's payment to terminate its license agreement with R constitutes a payment to terminate an exclusive license to use the taxpayer's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, N must capitalize its \$5,000,000 payment to R.

Example 2. Termination of exclusive distribution agreement. On March 1, 2005, L, a manufacturer, enters into an agreement with M granting M the right to be the sole distributor of L's products in state X for 10 years. On July 1, 2008, L pays M \$50,000 in exchange for M's agreement to terminate the distribution agreement. L's payment to terminate its agreement with M constitutes a payment to terminate an exclusive right to acquire L's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, L must capitalize its \$50,000 payment to M.

Example 3. Termination of covenant not to compete. On February 1, 2005, Y corporation enters into a covenant not to compete with Z corporation that prohibits Y from competing with Z in city V for a period of 5 years. On January 31, 2007, Y pays Z \$1,000,000 in exchange for Z's agreement to terminate the covenant not to compete. Y's payment to terminate the covenant not to compete with Z constitutes a payment to terminate an agreement that prohibits Y from competing with Z, as described in paragraph (d)(7)(i)(C) of this section. Accordingly, Y must capitalize its \$1,000,000 payment to Z.

Example 4. Termination of merger agreement. N corporation and U corporation enter into an agreement under which N agrees to merge into U. Subsequently, N pays U \$10,000,000 to terminate the merger agreement. As provided in paragraph (d)(7)(ii) of this section, N's \$10,000,000 payment to terminate the merger agreement with U is not required to be capitalized under this paragraph (d)(7). In addition, N's \$10,000,000 does not create a separate and distinct intangible asset for N within the meaning of paragraph (b)(3)(i) of this section. (See §1.263(a)-5 for additional

rules regarding termination of merger agreements).

(8) *Certain benefits arising from the provision, production, or improvement of real property—(i) In general.* A taxpayer must capitalize amounts paid for real property if the taxpayer transfers ownership of the real property to another person (except to the extent the real property is sold for fair market value) and if the real property can reasonably be expected to produce significant economic benefits to the taxpayer after the transfer. A taxpayer also must capitalize amounts paid to produce or improve real property owned by another (except to the extent the taxpayer is selling services at fair market value to produce or improve the real property) if the real property can reasonably be expected to produce significant economic benefits for the taxpayer.

(ii) *Exclusions.* A taxpayer is not required to capitalize an amount under paragraph (d)(8)(i) of this section if the taxpayer transfers real property or pays an amount to produce or improve real property owned by another in exchange for services, the purchase or use of property, or the creation of an intangible described in paragraph (d) of this section (other than in this paragraph (d)(8)). The preceding sentence does not apply to the extent the taxpayer does not receive fair market value consideration for the real property that is relinquished or for the amounts that are paid by the taxpayer to produce or improve real property owned by another.

(iii) *Real property.* For purposes of this paragraph (d)(8), real property includes property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as roads, bridges, tunnels, pavements, wharves and docks, breakwaters and sea walls, elevators, power generation and transmission facilities, and pollution control facilities.

(iv) *Impact fees and dedicated improvements.* Paragraph (d)(8)(i) of this section does not apply to amounts paid to satisfy one-time charges imposed by a State or local government against new development (or expansion of existing development) to finance specific offsite capital improvements for general public use that are necessitated by the new

or expanded development. In addition, paragraph (d)(8)(i) of this section does not apply to amounts paid for real property or improvements to real property constructed by the taxpayer where the real property or improvements benefit new development or expansion of existing development, are immediately transferred to a State or local government for dedication to the general public use, and are maintained by the State or local government. See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in this paragraph (d)(8)(iv).

(v) *Examples.* The following examples illustrate the rules of this paragraph (d)(8):

Example 1. Amount paid to produce real property owned by another. W corporation operates a quarry on the east side of a river in city Z and a crusher on the west side of the river. City Z's existing bridges are of insufficient capacity to be traveled by trucks in transferring stone from W's quarry to its crusher. As a result, the efficiency of W's operations is greatly reduced. W contributes \$1,000,000 to city Z to defray in part the cost of constructing a publicly owned bridge capable of accommodating W's trucks. W's payment to city Z is an amount paid to produce or improve real property (within the meaning of paragraph (d)(8)(iii) of this section) that can reasonably be expected to produce significant economic benefits for W. Under paragraph (d)(8)(i) of this section, W must capitalize the \$1,000,000 paid to city Z.

Example 2. Transfer of real property to another. K corporation, a shipping company, uses smaller vessels to unload its ocean-going vessels at port X. There is no natural harbor at port X, and during stormy weather the transfer of freight between K's ocean vessels and port X is extremely difficult and sometimes impossible, which can be very costly to K. Consequently, K constructs a short breakwater at a cost of \$50,000. The short breakwater, however, is inadequate, so K persuades the port authority to build a larger breakwater that will allow K to unload its vessels at any time of the year and during all kinds of weather. K contributes the short breakwater and pays \$200,000 to the port authority for use in building the larger breakwater. Because the transfer of the small breakwater and \$200,000 is reasonably expected to produce significant economic benefits for K, K must capitalize both the adjusted basis of the small breakwater (determined at the time the small breakwater is contributed) and the \$200,000 payment under this paragraph (d)(8).

Example 3. Dedicated improvements. X corporation is engaged in the development and sale of residential real estate. In connection with a residential real estate project under construction by X in city Z, X is required by city Z to construct ingress and egress roads to and from its project and immediately transfer the roads to city Z for dedication to general public use. The roads will be maintained by city Z. X pays its subcontractor \$100,000 to construct the ingress and egress roads. X's payment is a dedicated improvement within the meaning of paragraph (d)(8)(iv) of this section. Accordingly, X is not required to capitalize the \$100,000 payment under this paragraph (d)(8). See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in paragraph (d)(8)(iv) of this section.

(9) *Defense or perfection of title to intangible property—(i) In general.* A taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer's title to the intangible property.

(ii) *Certain break-up fees.* Paragraph (d)(9)(i) of this section does not apply to the termination of a transaction described in § 1.263(a)-5(a) (relating to an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions). See § 1.263(a)-5 for rules governing the treatment of amounts paid to terminate a transaction to which that section applies. Paragraph (d)(9)(i) of this section also does not apply to an amount paid to another party to terminate an agreement that grants that party the right to purchase the taxpayer's intangible property.

(iii) *Example.* The following example illustrates the rules of this paragraph (d)(9):

Example. Defense of title. R corporation claims to own an exclusive patent on a particular technology. U corporation brings a lawsuit against R, claiming that U is the true owner of the patent and that R stole the technology from U. The sole issue in the suit involves the validity of R's patent. R chooses to settle the suit by paying U \$100,000 in exchange for U's release of all future claim to the patent. R's payment to U is an amount paid to defend or perfect title to intangible property under paragraph (d)(9) of this section and must be capitalized.

(e) *Transaction costs*—(1) *Scope of facilitate*—(i) *In general*. Except as otherwise provided in this section, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction.

(ii) *Treatment of termination payments*. An amount paid to terminate (or facilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement under this section. See paragraph (d)(6)(iii) of this section for the treatment of termination fees paid to the other party (or parties) of a renegotiated agreement.

(iii) *Special rule for contracts*. An amount is treated as not paid in the process of investigating or otherwise pursuing the creation of an agreement described in paragraph (d)(2) or (d)(6) of this section if the amount relates to activities performed before the earlier of the date the taxpayer begins preparing its bid for the agreement or the date the taxpayer begins discussing or negotiating the agreement with another party to the agreement.

(iv) *Borrowing costs*. An amount paid to facilitate a borrowing does not facilitate an acquisition or creation of an intangible described in paragraphs (b)(1)(i) through (iv) of this section. See §§1.263(a)-5 and 1.446-5 for the treatment of an amount paid to facilitate a borrowing.

(v) *Special rule for stock redemption costs of open-end regulated investment companies*. An amount paid by an open-end regulated investment company (within the meaning of section 851) to facilitate a redemption of its stock is treated as an amount that does not fa-

facilitate the acquisition of an intangible under this section.

(2) *Coordination with paragraph (d) of this section*. In the case of an amount paid to facilitate the creation of an intangible described in paragraph (d) of this section, the provisions of this paragraph (e) apply regardless of whether a payment described in paragraph (d) is made.

(3) *Transaction*. For purposes of this section, the term *transaction* means all of the factual elements comprising an acquisition or creation of an intangible and includes a series of steps carried out as part of a single plan. Thus, a transaction can involve more than one invoice and more than one intangible. For example, a purchase of intangibles under one purchase agreement constitutes a single transaction, notwithstanding the fact that the acquisition involves multiple intangibles and the amounts paid to facilitate the acquisition are capable of being allocated among the various intangibles acquired.

(4) *Simplifying conventions*—(i) *In general*. For purposes of this section, employee compensation (within the meaning of paragraph (e)(4)(ii) of this section), overhead, and *de minimis* costs (within the meaning of paragraph (e)(4)(iii) of this section) are treated as amounts that do not facilitate the acquisition or creation of an intangible.

(ii) *Employee compensation*—(A) *In general*. The term *employee compensation* means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(B) *Certain amounts treated as employee compensation*. For purposes of this section, a guaranteed payment to a partner in a partnership is treated as employee compensation. For purposes of this section, annual compensation paid to a director of a corporation is treated as employee compensation. For example, an amount paid to a director of a corporation for attendance at a regular meeting of the board of directors (or committee thereof) is treated as employee compensation for purposes

of this section. However, an amount paid to a director for attendance at a special meeting of the board of directors (or committee thereof) is not treated as employee compensation. An amount paid to a person that is not an employee of the taxpayer (including the employer of the individual who performs the services) is treated as employee compensation for purposes of this section only if the amount is paid for secretarial, clerical, or similar administrative support services. In the case of an affiliated group of corporations filing a consolidated Federal income tax return, a payment by one member of the group to a second member of the group for services performed by an employee of the second member is treated as employee compensation if the services provided by the employee are provided at a time during which both members are affiliated.

(iii) *De minimis costs*—(A) *In general.* Except as provided in paragraph (e)(4)(iii)(B) of this section, the term *de minimis costs* means amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction if, in the aggregate, the amounts do not exceed \$5,000 (or such greater amount as may be set forth in published guidance). If the amounts exceed \$5,000 (or such greater amount as may be set forth in published guidance), none of the amounts are *de minimis costs* within the meaning of this paragraph (e)(4)(iii)(A). For purposes of this paragraph (e)(4)(iii), an amount paid in the form of property is valued at its fair market value at the time of the payment. In determining the amount of transaction costs paid in the process of investigating or otherwise pursuing a transaction, a taxpayer generally must account for the specific costs paid with respect to each transaction. However, a taxpayer that reasonably expects to enter into at least 25 similar transactions during the taxable year may establish a pool of similar transactions for purposes of determining the amount of transaction costs paid in the process of investigating or otherwise pursuing the transactions in the pool. Under this pooling method, the amount of transaction costs paid in the process of in-

vestigating or otherwise pursuing each transaction included in the pool is equal to the average transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool. A taxpayer computes the average transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool by dividing the sum of all transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool by the number of transactions included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(B) *Treatment of commissions.* The term *de minimis costs* does not include commissions paid to facilitate the acquisition of an intangible described in paragraphs (c)(1)(i) through (v) of this section or to facilitate the creation, origination, entrance into, renewal or renegotiation of an intangible described in paragraph (d)(2)(i) of this section.

(iv) *Election to capitalize.* A taxpayer may elect to treat employee compensation, overhead, or *de minimis costs* paid in the process of investigating or otherwise pursuing a transaction as amounts that facilitate the transaction. The election is made separately for each transaction and applies to employee compensation, overhead, or *de minimis costs*, or to any combination thereof. For example, a taxpayer may elect to treat overhead and *de minimis costs*, but not employee compensation, as amounts that facilitate the transaction. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the transaction in the taxpayer's timely filed original Federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph

(e)(4)(iv) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(5) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. Costs to facilitate. In December 2005, R corporation, a calendar year taxpayer, enters into negotiations with X corporation to lease commercial property from X for a period of 25 years. R pays A, its outside legal counsel, \$4,000 in December 2005 for services rendered by A during December in assisting with negotiations with X. In January 2006, R and X finalize the terms of the lease and execute the lease agreement. R pays B, another of its outside legal counsel, \$2,000 in January 2006 for services rendered by B during January in drafting the lease agreement. The agreement between R and X is an agreement providing R the right to use property, as described in paragraph (d)(6)(i)(A) of this section. R's payments to its outside counsel are amounts paid to facilitate the creation of the agreement. As provided in paragraph (e)(4)(iii)(A) of this section, R must aggregate its transaction costs for purposes of determining whether the transaction costs are *de minimis*. Because R's aggregate transaction costs exceed \$5,000, R's transaction costs are not *de minimis* costs within the meaning of paragraph (e)(4)(iii)(A) of this section. Accordingly, R must capitalize the \$4,000 paid to A and the \$2,000 paid to B under paragraph (b)(1)(v) of this section.

Example 2. Costs to facilitate. Partnership X leases its manufacturing equipment from Y corporation under a 10-year lease. During 2005, when the lease has a remaining term of 4 years, X enters into a written agreement with Z corporation, a competitor of Y, under which X agrees to lease its manufacturing equipment from Z, subject to the condition that X first successfully terminates its lease with Y. X pays Y \$50,000 in exchange for Y's agreement to terminate the equipment lease. Under paragraph (e)(1)(ii), X's \$50,000 payment does not facilitate the creation of the new lease with Z. In addition, X's \$50,000 payment does not terminate an agreement described in paragraph (d)(7) of this section. Accordingly, X is not required to capitalize the \$50,000 termination payment under this section.

Example 3. Costs to facilitate. W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 5 years. W pays its outside counsel \$7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. Under paragraph (e)(1)(i) of this section,

W's payment to its outside counsel is an amount paid to facilitate the creation of that agreement. As provided by paragraph (e)(2) of this section, W must capitalize its \$7,000 payment to outside counsel notwithstanding the fact that W made no payment described in paragraph (d)(6)(i) of this section.

Example 4. Costs to facilitate. U corporation, which owns a majority of the common stock of T corporation, votes its controlling interest in favor of a perpetual extension of T's charter. M, a minority shareholder in T, votes against the extension. Under applicable state law, U is required to purchase the stock of T held by M. When U and M are unable to agree on the value of M's shares, U brings an action in state court to appraise the value of M's stock interest. U pays attorney, accountant and appraisal fees of \$25,000 for services rendered in connection with the negotiation and litigation with M. Because U's attorney, accountant and appraisal costs help establish the purchase price of M's stock, U's \$25,000 payment facilitates the acquisition of stock. Accordingly, U must capitalize the \$25,000 payment under paragraph (b)(1)(v) of this section.

Example 5. Costs to facilitate. For several years, H corporation has provided services to J corporation whenever requested by J. H wants to enter into a multiple-year contract with J that would give H the right to provide services to J. On June 10, 2004, H starts to prepare a bid to provide services to J and pays a consultant \$15,000 to research potential competitors. On August 10, 2004, H raises the possibility of a multi-year contract with J. On October 10, 2004, H and J enter into a contract giving H the right to provide services to J for five years. During 2004, H pays \$7,000 to travel to the city in which J's offices are located to continue providing services to J under their prior arrangement and pays \$6,000 for travel to the city in which J's offices are located to further develop H's business relationship with J (for example, to introduce new employees, update J on current developments and take J's executives to dinner). H also pays \$3,000 for travel costs to meet with J to discuss and negotiate the contract. Because the contract gives H the right to provide services to J, H must capitalize amounts paid to facilitate the creation of the contract. The \$7,000 of travel expenses paid to provide services to J under their prior arrangement does not facilitate the creation of the contract and is not required to be capitalized, regardless of when the travel occurs. The \$6,000 of travel expenses paid to further develop H's business relationship with J is paid in the process of pursuing the contract (and therefore must be capitalized) only to the extent the expenses relate to travel on or after June 10, 2004 (the date H begins to prepare a bid) and before October 11, 2004 (the date after H and J enter

into the contract). The \$8,000 of travel expenses paid to meet with J to discuss and negotiate the contract is paid in the process of pursuing the contract and must be capitalized. The \$15,000 of consultant fees is paid to investigate the contract and also must be capitalized.

Example 6. Costs that do not facilitate. X corporation brings a legal action against Y corporation to recover lost profits resulting from Y's alleged infringement of X's copyright. Y does not challenge X's copyright, but argues that it did not infringe upon X's copyright. X pays its outside counsel \$25,000 for legal services rendered in pursuing the suit against Y. Because X's title to its copyright is not in question, X's action against Y does not involve X's defense or perfection of title to intangible property. Thus, the amount paid to outside counsel does not facilitate the creation of an intangible described in paragraph (d)(9) of this section. Accordingly, X is not required to capitalize its \$25,000 payment under this section.

Example 7. De minimis rule. W corporation, a commercial bank, acquires a portfolio containing 100 loans from Y corporation. As part of the acquisition, W pays an independent appraiser a fee of \$10,000 to appraise the portfolio. The fee is an amount paid to facilitate W's acquisition of an intangible. The acquisition of the loan portfolio is a single transaction within the meaning of paragraph (e)(3) of this section. Because the amount paid to facilitate the transaction exceeds \$5,000, the amount is not *de minimis* as defined in paragraph (e)(4)(iii)(A) of this section. Accordingly, W must capitalize the \$10,000 fee under paragraph (b)(1)(v) of this section.

Example 8. Compensation and overhead. P corporation, a commercial bank, maintains a loan acquisition department whose sole function is to acquire loans from other financial institutions. As provided in paragraph (e)(4)(i) of this section, P is not required to capitalize any portion of the compensation paid to the employees in its loan acquisition department or any portion of its overhead allocable to the loan acquisition department.

(f) *12-month rule—(1) In general.* Except as otherwise provided in this paragraph (f), a taxpayer is not required to capitalize under this section amounts paid to create (or to facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of—

(i) 12 months after the first date on which the taxpayer realizes the right or benefit; or

(ii) The end of the taxable year following the taxable year in which the payment is made.

(2) *Duration of benefit for contract terminations.* For purposes of this paragraph (f), amounts paid to terminate a contract or other agreement described in paragraph (d)(7)(i) of this section prior to its expiration date (or amounts paid to facilitate such termination) create a benefit for the taxpayer that lasts for the unexpired term of the agreement immediately before the date of the termination. If the terms of a contract or other agreement described in paragraph (d)(7)(i) of this section permit the taxpayer to terminate the contract or agreement after a notice period, amounts paid by the taxpayer to terminate the contract or agreement before the end of the notice period create a benefit for the taxpayer that lasts for the amount of time by which the notice period is shortened.

(3) *Inapplicability to created financial interests and self-created amortizable section 197 intangibles.* Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible described in paragraph (d)(2) of this section (relating to amounts paid to create financial interests) or to amounts paid to create (or facilitate the creation of) an intangible that constitutes an amortizable section 197 intangible within the meaning of section 197(c).

(4) *Inapplicability to rights of indefinite duration.* Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible of indefinite duration. A right has an indefinite duration if it has no period of duration fixed by agreement or by law, or if it is not based on a period of time, such as a right attributable to an agreement to provide or receive a fixed amount of goods or services. For example, a license granted by a governmental agency that permits the taxpayer to operate a business conveys a right of indefinite duration if the license may be revoked only upon the taxpayer's violation of the terms of the license.

(5) *Rights subject to renewal—(i) In general.* For purposes of paragraph (f)(1) of this section, the duration of a right includes any renewal period if all of the facts and circumstances in existence during the taxable year in which the

right is created indicate a reasonable expectancy of renewal.

(ii) *Reasonable expectancy of renewal.* The following factors are significant in determining whether there exists a reasonable expectancy of renewal:

(A) *Renewal history.* The fact that similar rights are historically renewed is evidence of a reasonable expectancy of renewal. On the other hand, the fact that similar rights are rarely renewed is evidence of a lack of a reasonable expectancy of renewal. Where the taxpayer has no experience with similar rights, or where the taxpayer holds similar rights only occasionally, this factor is less indicative of a reasonable expectancy of renewal.

(B) *Economics of the transaction.* The fact that renewal is necessary for the taxpayer to earn back its investment in the right is evidence of a reasonable expectancy of renewal. For example, if a taxpayer pays \$14,000 to enter into a renewable contract with an initial 9-month term that is expected to generate income to the taxpayer of \$1,000 per month, the fact that renewal is necessary for the taxpayer to earn back its \$14,000 payment is evidence of a reasonable expectancy of renewal.

(C) *Likelihood of renewal by other party.* Evidence that indicates a likelihood of renewal by the other party to a right, such as a bargain renewal option or similar arrangement, is evidence of a reasonable expectancy of renewal. However, the mere fact that the other party will have the opportunity to renew on the same terms as are available to others is not evidence of a reasonable expectancy of renewal.

(D) *Terms of renewal.* The fact that material terms of the right are subject to renegotiation at the end of the initial term is evidence of a lack of a reasonable expectancy of renewal. For example, if the parties to an agreement must renegotiate price or amount, the renegotiation requirement is evidence of a lack of a reasonable expectancy of renewal.

(E) *Terminations.* The fact that similar rights are typically terminated prior to renewal is evidence of a lack of a reasonable expectancy of renewal.

(iii) *Safe harbor pooling method.* In lieu of applying the reasonable expectancy of renewal test described in para-

graph (f)(5)(ii) of this section to each separate right created during a taxable year, a taxpayer that reasonably expects to enter into at least 25 similar rights during the taxable year may establish a pool of similar rights for which the initial term does not extend beyond the period prescribed in paragraph (f)(1) of this section and may elect to apply the reasonable expectancy of renewal test to that pool. See paragraph (h) of this section for additional rules relating to pooling. The application of paragraph (f)(1) of this section to each pool is determined in the following manner:

(A) All amounts (except *de minimis* costs described in paragraph (d)(6)(v) of this section) paid to create the rights included in the pool and all amounts paid to facilitate the creation of the rights included in the pool are aggregated.

(B) If less than 20 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that does not extend beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is not required to capitalize under this section any portion of the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(C) If more than 80 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that extends beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is required to capitalize under this section the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(D) If 20 percent or more, but 80 percent or less, of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, the aggregate amount described in paragraph (f)(5)(iii)(A) of this section is multiplied by the percentage of the rights in the pool that are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section and the taxpayer must capitalize

the resulting amount under this section by treating such amount as creating a separate intangible. The amount determined by multiplying the aggregate amount described in paragraph (f)(5)(iii)(A) of this section by the percentage of rights in the pool that are not reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section is not required to be capitalized under this section.

(6) *Coordination with section 461.* In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See § 1.461-4 for rules relating to economic performance.

(7) *Election to capitalize.* A taxpayer may elect not to apply the rule contained in paragraph (f)(1) of this section. An election made under this paragraph (f)(7) applies to all similar transactions during the taxable year to which paragraph (f)(1) of this section would apply (but for the election under this paragraph (f)(7)). For example, a taxpayer may elect under this paragraph (f)(7) to capitalize its costs of prepaying insurance contracts for 12 months, but may continue to apply the rule in paragraph (f)(1) to its costs of entering into non-renewable, 12-month service contracts. A taxpayer makes the election by treating the amounts as capital expenditures in its timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (f)(7) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(8) *Examples.* The rules of this paragraph (f) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer is a calendar year, accrual method taxpayer that does not have a short taxable year in any taxable year and has not made an election under paragraph (f)(7) of this section:

Example 1. Prepaid expenses. On December 1, 2005, N corporation pays a \$10,000 insurance premium to obtain a property insurance policy (with no cash value) with a 1-year term that begins on February 1, 2006. The amount paid by N is a prepaid expense described in paragraph (d)(3) of this section and not paragraph (d)(2) of this section. Because the right or benefit attributable to the \$10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule provided by this paragraph (f) does not apply. N must capitalize the \$10,000 payment.

Example 2. Prepaid expenses. (i) Assume the same facts as in *Example 1*, except that the policy has a term beginning on December 15, 2005. The 12-month rule of this paragraph (f) applies to the \$10,000 payment because the right or benefit attributable to the payment neither extends more than 12 months beyond December 15, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, N is not required to capitalize the \$10,000 payment.

(ii) Alternatively, assume N capitalizes prepaid expenses for financial accounting and reporting purposes and elects under paragraph (f)(7) of this section not to apply the 12-month rule contained in paragraph (f)(1) of this section. N must capitalize the \$10,000 payment for Federal income tax purposes.

Example 3. Financial interests. On October 1, 2005, X corporation makes a 9-month loan to B in the principal amount of \$250,000. The principal amount of the loan to B constitutes an amount paid to create or originate a financial interest under paragraph (d)(2)(i)(B) of this section. The 9-month term of the loan does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, X must capitalize the \$250,000 loan amount.

Example 4. Financial interests. X corporation owns all of the outstanding stock of Z corporation. On December 1, 2005, Y corporation pays X \$1,000,000 in exchange for X's grant of a 9-month call option to Y permitting Y to purchase all of the outstanding stock of Z.

Y's payment to X constitutes an amount paid to create or originate an option with X under paragraph (d)(2)(i)(C)(7) of this section. The 9-month term of the option does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, Y must capitalize the \$1,000,000 payment.

Example 5. License. (i) On July 1, 2005, R corporation pays \$10,000 to state X to obtain a license to operate a business in state X for a period of 5 years. The terms of the license require R to pay state X an annual fee of \$500 due on July 1, 2005, and each of the succeeding four years. R pays the \$500 fee on July 1 as required by the license.

(ii) R's payment of \$10,000 is an amount paid to a governmental agency for a license granted by that agency to which paragraph (d)(5) of this section applies. Because R's payment creates rights or benefits for R that extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and beyond the end of 2006 (the taxable year following the taxable year in which the payment is made), the rules of this paragraph (f) do not apply to R's payment. Accordingly, R must capitalize the \$10,000 payment.

(iii) R's payment of each \$500 annual fee is a prepaid expense described in paragraph (d)(3) of this section. R is not required to capitalize the \$500 fee in each taxable year. The rules of this paragraph (f) apply to each such payment because each payment provides a right or benefit to R that does not extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and does not extend beyond the end of the taxable year following the taxable year in which the payment is made.

Example 6. Lease. On December 1, 2005, W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 9 months, beginning on December 1, 2005. W pays its outside counsel \$7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. W's \$7,000 payment to its outside counsel is an amount paid to facilitate W's creation of the lease as described in paragraph (e)(1)(i) of this section. The 12-month rule of this paragraph (f) applies to the \$7,000 payment because the right or benefit that the \$7,000 payment facilitates the creation of neither extends more than 12 months beyond December 1, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable

year in which the payment is made. Accordingly, W is not required to capitalize its payment to its outside counsel.

Example 7. Certain contract terminations. V corporation owns real property that it has leased to A for a period of 15 years. When the lease has a remaining unexpired term of 5 years, V and A agree to terminate the lease, enabling V to use the property in its trade or business. V pays A \$100,000 in exchange for A's agreement to terminate the lease. V's payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 5 years, the remaining unexpired term of the lease as of the date of the termination. Because the benefit attributable to the expenditure extends beyond 12 months after the first date on which V realizes the rights or benefits attributable to the payment and beyond the end of the taxable year following the taxable year in which the payment is made, the rules of this paragraph (f) do not apply to the payment. V must capitalize the \$100,000 payment.

Example 8. Certain contract terminations. Assume the same facts as in *Example 7*, except that the lease is terminated when it has a remaining unexpired term of 10 months. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 10 months. The 12-month rule of this paragraph (f) applies to the payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the \$100,000 payment.

Example 9. Certain contract terminations. Assume the same facts as in *Example 7*, except that either party can terminate the lease upon 12 months notice. When the lease has a remaining unexpired term of 5 years, V wants to terminate the lease, however, V does not want to wait another 12 months. V pays A \$50,000 for the ability to terminate the lease with one month's notice. V's payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 11 months, the time by which the notice period is shortened. The 12-month rule of this paragraph (f) applies to V's \$50,000 payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the \$50,000 payment.

Example 10. Coordination with section 461. (i) U corporation leases office space from W corporation at a monthly rental rate of \$2,000. On August 1, 2005, U prepays its office rent expense for the first six months of 2006 in the amount of \$12,000. For purposes of this example, it is assumed that the recurring item exception provided by § 1.461-5 does not apply and that the lease between W and U is not a section 467 rental agreement as defined in section 467(d).

(ii) Under § 1.461-4(d)(3), U's prepayment of rent is a payment for the use of property by U for which economic performance occurs ratably over the period of time U is entitled to use the property. Accordingly, because economic performance with respect to U's prepayment of rent does not occur until 2006, U's prepaid rent is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to U's prepayment of its rent.

(iii) Alternatively, assume that U uses the cash method of accounting and the economic performance rules in § 1.461-4 therefore do not apply to U. The 12-month rule of this paragraph (f) applies to the \$12,000 payment because the rights or benefits attributable to U's prepayment of its rent do not extend beyond December 31, 2006. Accordingly, U is not required to capitalize its prepaid rent.

Example 11. Coordination with section 461. N corporation pays R corporation, an advertising and marketing firm, \$40,000 on August 1, 2005, for advertising and marketing services to be provided to N throughout calendar year 2006. For purposes of this example, it is assumed that the recurring item exception provided by § 1.461-5 does not apply. Under § 1.461-4(d)(2), N's payment arises out of the provision of services to N by R for which economic performance occurs as the services are provided. Accordingly, because economic performance with respect to N's prepaid advertising expense does not occur until 2006, N's prepaid advertising expense is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to N's payment.

(g) *Treatment of capitalized costs*—(1) *In general.* An amount required to be capitalized by this section is not currently deductible under section 162. Instead, the amount generally is added to the basis of the intangible acquired or created. See section 1012.

(2) *Financial instruments.* In the case of a financial instrument described in paragraph (c)(1)(iii) or (d)(2)(i)(C) of this section, notwithstanding paragraph (g)(1) of this section, if under

other provisions of law the amount required to be capitalized is not required to be added to the basis of the intangible acquired or created, then the other provisions of law will govern the tax treatment of the amount.

(h) *Special rules applicable to pooling*—(1) *In general.* Except as otherwise provided, the rules of this paragraph (h) apply to the pooling methods described in paragraph (d)(6)(v) of this section (relating to *de minimis* rules applicable to certain contract rights), paragraph (e)(4)(iii)(A) of this section (relating to *de minimis* rules applicable to transaction costs), and paragraph (f)(5)(iii) of this section (relating to the application of the 12-month rule to renewable rights).

(2) *Method of accounting.* A pooling method authorized by this section constitutes a method of accounting for purposes of section 446. A taxpayer that adopts or changes to a pooling method authorized by this section must use the method for the year of adoption and for all subsequent taxable years during which the taxpayer qualifies to use the pooling method unless a change to another method is required by the Commissioner in order to clearly reflect income, or unless permission to change to another method is granted by the Commissioner as provided in § 1.446-1(e).

(3) *Adopting or changing to a pooling method.* A taxpayer adopts (or changes to) a pooling method authorized by this section for any taxable year by establishing one or more pools for the taxable year in accordance with the rules governing the particular pooling method and the rules prescribed by this paragraph (h), and by using the pooling method to compute its taxable income for the year of adoption (or change).

(4) *Definition of pool.* A taxpayer may use any reasonable method of defining a pool of similar transactions, agreements or rights, including a method based on the type of customer or the type of product or service provided under a contract. However, a taxpayer that pools similar transactions, agreements or rights must include in the pool all similar transactions, agreements or rights created during the taxable year. For purposes of the pooling methods described in paragraph

(d)(6)(v) of this section (relating to *de minimis* rules applicable to certain contract rights) and paragraph (e)(4)(iii)(A) of this section (relating to *de minimis* rules applicable to transaction costs), an agreement (or a transaction) is treated as not similar to other agreements (or transactions) included in the pool if the amount at issue with respect to that agreement (or transaction) is reasonably expected to differ significantly from the average amount at issue with respect to the other agreements (or transactions) properly included in the pool.

(5) *Consistency requirement.* A taxpayer that uses the pooling method described in paragraph (f)(5)(iii) of this section for purposes of applying the 12-month rule to a right or benefit—

(i) Must use the pooling methods described in paragraph (d)(6)(v) of this section (relating to *de minimis* rules applicable to certain contract rights) and paragraph (e)(4)(iii)(A) of this section (relating to *de minimis* rules applicable to transaction costs) for purposes of determining the amount paid to create, or facilitate the creation of, the right or benefit; and

(ii) Must use the same pool for purposes of paragraph (d)(6)(v) of this section and paragraph (e)(4)(iii)(A) of this section as is used for purposes of paragraph (f)(5)(iii) of this section.

(6) *Additional guidance pertaining to pooling.* The Internal Revenue Service may publish guidance in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) prescribing additional rules for applying the pooling methods authorized by this section to specific industries or to specific types of transactions.

(7) *Example.* The following example illustrates the rules of this paragraph (h):

Example. Pooling. (i) In the course of its business, W corporation enters into 3-year non-cancelable contracts that provide W the right to provide services to its customers. W generally pays certain amounts in the process of pursuing an agreement with a customer, including amounts paid to credit reporting agencies to verify the credit history of the potential customer and commissions paid to the independent sales agent who secures the agreement with the customer. In the case of agreements that W enters into with customers who are individuals, the

agreements contain substantially similar terms and conditions and W typically pays between \$100 and \$200 in the process of pursuing each transaction. During 2005, W enters into agreements with 300 individuals. Also during 2005, W enters into an agreement with X corporation containing terms and conditions that are substantially similar to those contained in the agreements W enters into with its customers who are individuals. W pays certain amounts in the process of pursuing the agreement with X that W would not typically incur in the process of pursuing an agreement with its customers who are individuals. For example, W pays amounts to prepare and submit a bid for the agreement with X and amounts to travel to X's headquarters to make a sales presentation to X's management. In the aggregate, W pays \$11,000 in the process of obtaining the agreement with X.

(ii) The agreements between W and its customers are agreements providing W the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Under paragraph (b)(1)(v) of this section, W must capitalize transaction costs paid to facilitate the creation of these agreements. Because W enters into at least 25 similar transactions during 2005, W may pool its transactions for purposes of determining whether its transaction costs are *de minimis* within the meaning of paragraph (e)(4)(iii)(A) of this section. W adopts a pooling method by establishing one or more pools of similar transactions and by using the pooling method to compute its taxable income beginning in its 2005 taxable year. If W adopts a pooling method, W must include all similar transactions in the pool. Under paragraph (h)(4) of this section, the transaction with X is not similar to the transactions W enters into with its customers who are individuals. While the agreement with X contains terms and conditions that are substantially similar to those contained in the agreements W enters into with its customers who are individuals, the transaction costs paid in the process of pursuing the agreement with X are reasonably expected to differ significantly from the average transaction costs attributable to transactions with its customers who are individuals. Accordingly, W may not include the transaction with X in the pool of transactions with customers who are individuals.

(i) [Reserved]

(j) *Application to accrual method taxpayers.* For purposes of this section, the terms *amount paid* and *payment* mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of § 1.446-1(c)(1)(ii)). A liability may not be taken into account under this section prior to

the taxable year during which the liability is incurred.

(k) *Treatment of related parties and indirect payments.* For purposes of this section, references to a party other than the taxpayer include persons related to that party and persons acting for or on behalf of that party (including persons to whom the taxpayer becomes obligated as a result of assuming a liability of that party). For this purpose, persons are related only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1). References to an amount paid to or by a party include an amount paid on behalf of that party.

(l) *Examples.* The rules of this section are illustrated by the following examples in which it is assumed that the Internal Revenue Service has not published guidance that requires capitalization under paragraph (b)(1)(iv) of this section (relating to amounts paid to create or enhance a future benefit that is identified in published guidance as an intangible for which capitalization is required):

Example 1. License granted by a governmental unit. (i) X corporation pays \$25,000 to state R to obtain a license to sell alcoholic beverages in its restaurant. The license is valid indefinitely, provided X complies with all applicable laws regarding the sale of alcoholic beverages in state R. X pays its outside counsel \$4,000 for legal services rendered in preparing the license application and otherwise representing X during the licensing process. In addition, X determines that \$2,000 of salaries paid to its employees is allocable to services rendered by the employees in obtaining the license.

(ii) X's payment of \$25,000 is an amount paid to a governmental unit to obtain a license granted by that agency, as described in paragraph (d)(5)(i) of this section. The right has an indefinite duration and constitutes an amortizable section 197 intangible. Accordingly, as provided in paragraph (f)(3) of this section, the provisions of paragraph (f) of this section (relating to the 12-month rule) do not apply to X's payment. X must capitalize its \$25,000 payment to obtain the license from state R.

(iii) As provided in paragraph (e)(4) of this section, X is not required to capitalize employee compensation because such amounts are treated as amounts that do not facilitate the acquisition or creation of an intangible. Thus, X is not required to capitalize the

\$2,000 of employee compensation allocable to the transaction.

(iv) X's payment of \$4,000 to its outside counsel is an amount paid to facilitate the creation of an intangible, as described in paragraph (e)(1)(i) of this section. Because X's transaction costs do not exceed \$5,000, X's transaction costs are *de minimis* within the meaning of paragraph (e)(4)(iii)(A) of this section. Accordingly, X is not required to capitalize the \$4,000 payment to its outside counsel under this section.

Example 2. Franchise agreement. (i) R corporation is a franchisor of income tax return preparation outlets. V corporation negotiates with R to obtain the right to operate an income tax return preparation outlet under a franchise from R. V pays an initial \$100,000 franchise fee to R in exchange for the franchise agreement. In addition, V pays its outside counsel \$4,000 to represent V during the negotiations with R. V also pays \$2,000 to an industry consultant to advise V during the negotiations with R.

(ii) Under paragraph (d)(6)(i)(A) of this section, V's payment of \$100,000 is an amount paid to another party to enter into an agreement with that party providing V the right to use tangible or intangible property. Accordingly, V must capitalize its \$100,000 payment to R. The franchise agreement is a self-created amortizable section 197 intangible within the meaning of section 197(c). Accordingly, as provided in paragraph (f)(3) of this section, the 12-month rule contained in paragraph (f)(1) of this section does not apply.

(iii) V's payment of \$4,000 to its outside counsel and \$2,000 to the industry consultant are amounts paid to facilitate the creation of an intangible, as described in paragraph (e)(1)(i) of this section. Because V's aggregate transaction costs exceed \$5,000, V's transaction costs are not *de minimis* within the meaning of paragraph (e)(4)(iii)(A) of this section. Accordingly, V must capitalize the \$4,000 payment to its outside counsel and the \$2,000 payment to the industry consultant under this section into the basis of the franchise, as provided in paragraph (g) of this section.

Example 3. Covenant not to compete. (i) On December 1, 2005, N corporation, a calendar year taxpayer, enters into a covenant not to compete with B, a key employee that is leaving the employ of N. The covenant not to compete is not entered into in connection with the acquisition of an interest in a trade or business. The covenant not to compete prohibits B from competing with N for a period of 9 months, beginning December 1, 2005. N pays B \$25,000 in full consideration for B's agreement not to compete. In addition, N pays its outside counsel \$6,000 to facilitate the creation of the covenant not to compete with B. N does not have a short taxable year in 2005 or 2006.

(ii) Under paragraph (d)(6)(i)(C) of this section, N's payment of \$25,000 is an amount paid to another party to induce that party to enter into a covenant not to compete with N. However, because the covenant not to compete has a duration that does not extend beyond 12 months after the first date on which N realizes the rights attributable to its payment (*i.e.*, December 1, 2005) or beyond the end of the taxable year following the taxable year in which payment is made, the 12-month rule contained in paragraph (f)(1) of this section applies. Accordingly, N is not required to capitalize its \$25,000 payment to B or its \$6,000 payment to facilitate the creation of the covenant not to compete.

Example 4. Demand-side management. (i) X corporation, a public utility engaged in generating and distributing electrical energy, provides programs to its customers to promote energy conservation and energy efficiency. These programs are aimed at reducing electrical costs to X's customers, building goodwill with X's customers, and reducing X's future operating and capital costs. X provides these programs without obligating any of its customers participating in the programs to purchase power from X in the future. Under these programs, X pays a consultant to help industrial customers design energy-efficient manufacturing processes, to conduct "energy efficiency audits" that serve to identify for customers inefficiencies in their energy usage patterns, and to provide cash allowances to encourage residential customers to replace existing appliances with more energy efficient appliances.

(ii) The amounts paid by X to the consultant are not amounts to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to the consultant are not required to be capitalized under this section. While the amounts may serve to reduce future operating and capital costs and create goodwill with customers, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 5. Business process re-engineering. (i) V corporation manufactures its products using a batch production system. Under this system, V continuously produces component parts of its various products and stockpiles these parts until they are needed in V's final assembly line. Finished goods are stockpiled awaiting orders from customers. V discovers that this process ties up significant amounts of V's capital in work-in-process and finished goods inventories. V hires B, a consultant, to advise V on improving the efficiency of its manufacturing operations. B recommends a complete re-engineering of V's manufacturing process to a process known as just-in-

time manufacturing. Just-in-time manufacturing involves reconfiguring a manufacturing plant to a configuration of "cells" where each team in a cell performs the entire manufacturing process for a particular customer order, thus reducing inventory stockpiles.

(ii) V incurred three categories of costs to convert its manufacturing process to a just-in-time system. First, V paid B, a consultant, \$250,000 in professional fees to implement the conversion of V's plant to a just-in-time system. Second, V paid C, a contractor, \$100,000 to relocate and reconfigure V's manufacturing equipment from an assembly line layout to a configuration of cells. Third, V paid D, a consultant, \$50,000 to train V's employees in the just-in-time manufacturing process.

(iii) The amounts paid by V to B, C, and D are not amounts to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to B, C, and D are not required to be capitalized under this section. While the amounts produce long term benefits to V in the form of reduced inventory stockpiles, improved product quality, and increased efficiency, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 6. Defense of business reputation. (i) X, an investment adviser, serves as the fund manager of a money market investment fund. X, like its competitors in the industry, strives to maintain a constant net asset value for its money market fund of \$1.00 per share. During 2005, in the course of managing the fund assets, X incorrectly predicts the direction of market interest rates, resulting in significant investment losses to the fund. Due to these significant losses, X is faced with the prospect of reporting a net asset value that is less than \$1.00 per share. X is not aware of any investment adviser in its industry that has ever reported a net asset value for its money market fund of less than \$1.00 per share. X is concerned that reporting a net asset value of less than \$1.00 per share will significantly harm its reputation as an investment adviser, and could lead to litigation by shareholders. X decides to contribute \$2,000,000 to the fund in order to raise the net asset value of the fund to \$1.00 per share. This contribution is not a loan to the fund and does not give X any ownership interest in the fund.

(ii) The \$2,000,000 contribution is not an amount paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amount does not create a separate and distinct intangible

asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amount contributed to the fund is not required to be capitalized under this section. While the amount serves to protect the business reputation of the taxpayer and may protect the taxpayer from litigation by shareholders, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 7. Product launch costs. (i) R corporation, a manufacturer of pharmaceutical products, is required by law to obtain regulatory approval before selling its products. While awaiting regulatory approval on Product A, R pays to develop and implement a marketing strategy and an advertising campaign to raise consumer awareness of the purported need for Product A. R also pays to train health care professionals and other distributors in the proper use of Product A.

(ii) The amounts paid by R are not amounts paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, R is not required to capitalize these amounts under this section. While the amounts may benefit R by creating consumer demand for Product A and increasing awareness of Product A among distributors, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 8. Stocklifting costs. (i) N corporation is a wholesale distributor of Brand A aftermarket automobile replacement parts. In an effort to induce a retail automobile parts supply store to stock only Brand A parts, N offers to replace all of the store's inventory of other branded parts with Brand A parts, and to credit the store for its cost of other branded parts. The store is under no obligation to continue stocking Brand A parts or to purchase a minimum volume of Brand A parts from N in the future.

(ii) The amount paid by N as a credit to the store for the cost of other branded parts is not an amount paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amount does not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, N is not required to capitalize the amount under this section. While the amount may create a hope or expectation by N that the store will continue to stock Brand A parts, this benefit, without more, is not an intangible for which capitalization is required under this section.

(iii) Alternatively, assume that N agrees to credit the store for its cost of other branded parts in exchange for the store's agreement to purchase all of its inventory requirements

for such parts from N for a period of at least 3 years. The amount paid by N as a credit to the store for the cost of other branded parts is an amount paid to induce the store to enter into an agreement providing R the right to provide property. Accordingly, R must capitalize its payment.

Example 9. Package design costs. (i) Z corporation manufactures and markets personal care products. Z pays \$100,000 to a consultant to develop a package design for Z's newest product, Product A. Z also pays a fee to a government agency to obtain trademark and copyright protection on certain elements of the package design. Z pays its outside legal counsel \$10,000 for services rendered in preparing and filing the trademark and copyright applications and for other services rendered in securing the trademark and copyright protection.

(ii) The \$100,000 paid by Z to the consultant for development of the package design is not an amount paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, as provided in paragraph (b)(3)(v) of this section, amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset. Accordingly, Z is not required to capitalize the \$100,000 payment under this section.

(iii) The amounts paid by Z to the government agency to obtain trademark and copyright protection are amounts paid to a government agency for a right granted by that agency. Accordingly, Z must capitalize the payment. In addition, the \$10,000 paid by Z to its outside counsel is an amount paid to facilitate the creation of the trademark and copyright. Because the aggregate amounts paid to facilitate the transaction exceed \$5,000, the amounts are not *de minimis* as defined in paragraph (e)(4)(iii)(A) of this section. Accordingly, Z must capitalize the \$10,000 payment to its outside counsel under paragraph (b)(1)(v) of this section.

(iv) Alternatively, assume that Z acquires an existing package design for Product A as part of an acquisition of a trade or business that constitutes an applicable asset acquisition within the meaning of section 1060(c). Assume further that \$100,000 of the consideration paid by N in the acquisition is properly allocable to the package design for Product A. Under paragraph (c)(1) of this section, Z must capitalize the \$100,000 payment.

Example 10. Contract to provide services. (i) Q corporation, a financial planning firm, provides financial advisory services on a fee-only basis. During 2005, Q and several other financial planning firms submit separate bids to R corporation for a contract to become one of three providers of financial advisory services to R's employees. Q pays \$2,000 to a printing company to develop and produce materials for its sales presentation

to R's management. Q also pays \$6,000 to travel to R's corporate headquarters to make the sales presentation, and \$20,000 of salaries to its employees for services performed in preparing the bid and making the presentation to R's management. Q's bid is successful and Q enters into an agreement with R in 2005 under which Q agrees to provide financial advisory services to R's employees, and R agrees to pay Q's fee on behalf of each employee who chooses to utilize such services. R enters into similar agreements with two other financial planning firms, and R's employees may choose to use the services of any one of the three firms. Based on its past experience, Q reasonably expects to provide services to at least 5 percent of R's employees.

(i) Q's agreement with R is not an agreement providing Q the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Under paragraph (d)(6)(iv) the agreement places no obligation on another person to request or pay for Q's services. Accordingly, Q is not required to capitalize any of the amounts paid in the process of pursuing the agreement with R.

Example 11. Mutual fund distributor. (i) D incurs costs to enter into a distribution agreement with M, a mutual fund. The initial term of the distribution agreement is two years, and afterwards must be approved annually by M. The distribution agreement can be terminated by either party on 60 days notice. Although distribution agreements are rarely terminated in the mutual fund industry, M is not economically compelled to continue D's distribution agreement. Under the distribution agreement, D has the exclusive right to sell shares of M and agrees to use its best efforts to solicit orders for the sale of shares of M. D sells shares in M directly to the general public as well as through brokers. When an investor places an order for M shares with a broker, D pays the broker a commission for selling the shares to the investor. Under the distribution agreement, D receives compensation from M in the form of 12b-1 fees (which equal a percentage of M's net asset value attributable to investors that have held their shares for up to 6 years) and contingent deferred sales charges (which are paid if the investor redeems the purchased shares within 6 years).

(ii) The distribution agreement is not an agreement providing D with the right to provide services, as described in paragraph (d)(6)(i)(B) of this section, because the distribution agreement can be terminated by M at will upon 60 days notice and M is not economically compelled to continue the distribution agreement. Accordingly, D is not required to capitalize the costs of creating (or facilitating the creation of) the distribution agreement under paragraphs (b)(1)(ii) or (v) of this section. In addition, as provided in paragraph (b)(3)(ii) of this section, amounts

paid to create an agreement are treated as amounts that do not create a separate and distinct intangible asset. Accordingly, D also is not required to capitalize the costs of creating (or facilitating the creation of) the distribution agreement under paragraph (b)(1)(iii) or (v) of this section.

(iii) Under paragraph (b)(3)(iii), the broker commissions paid by D in performing services under the distribution agreement do not create (or facilitate the creation of) a separate and distinct intangible asset. In addition, the broker commissions do not create an intangible described in paragraph (d) of this section. Accordingly, D is not required to capitalize the broker commissions under this section.

(m) *Amortization.* For rules relating to amortization of certain intangibles, see § 1.167(a)-3.

(n) *Intangible interests in land.* [Reserved].

(o) *Effective date.* This section applies to amounts paid or incurred on or after December 31, 2003.

(p) *Accounting method changes—(1) In general.* A taxpayer seeking to change a method of accounting to comply with this section must secure the consent of the Commissioner in accordance with the requirements of § 1.446-1(e). For the taxpayer's first taxable year ending on or after December 31, 2003, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with this section, provided the taxpayer follows the administrative procedures issued under § 1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 C.B. 327) and § 601.601(d)(2)(ii)(b) of this chapter).

(2) *Scope limitations.* Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003.

(3) *Section 481(a) adjustment.* With the exception of a change to a pooling method authorized by this section, the section 481(a) adjustment for a change in method of accounting to comply with this section for a taxpayer's first taxable year ending on or after December 31, 2003 is determined by taking into account only amounts paid or incurred in taxable years ending on or

after January 24, 2002. A taxpayer seeking to change to a pooling method authorized by this section on or after the effective date of these regulations must change to the method using a cut-off method.

[T.D. 9107, 69 FR 446, Jan. 5, 2004]

§ 1.263(a)-5 Amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions.

(a) *General rule.* A taxpayer must capitalize an amount paid to facilitate (within the meaning of paragraph (b) of this section) each of the following transactions, without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction:

(1) An acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition).

(2) An acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b) or 707(b) (see § 1.263(a)-4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, or to facilitate the acquisition of an ownership interest in a business entity, where the taxpayer and the business entity are not related within the meaning of section 267(b) or 707(b) immediately after the acquisition).

(3) An acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise).

(4) A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in section 368 and distributions of stock by the taxpayer as described in section 355).

(5) A transfer described in section 351 or section 721 (whether the taxpayer is the transferor or transferee).

(6) A formation or organization of a disregarded entity.

(7) An acquisition of capital.

(8) A stock issuance.

(9) A borrowing. For purposes of this section, a borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization. A borrowing also includes debt issued in a debt for debt exchange under § 1.1001-3.

(10) Writing an option.

(b) *Scope of facilitate*—(1) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate a transaction described in paragraph (a) of this section if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange. For example, the purchase price paid to the target of an asset acquisition in exchange for its assets is not an amount paid to facilitate the acquisition. Similarly, the purchase price paid by an acquirer to the target's shareholders in exchange for their stock in a stock acquisition is not an amount paid to facilitate the acquisition of the stock. See § 1.263(a)-1, § 1.263(a)-2, and § 1.263(a)-4 for rules requiring capitalization of the purchase price paid to acquire property.

(2) *Ordering rules.* An amount paid in the process of investigating or otherwise pursuing both a transaction described in paragraph (a) of this section and an acquisition or creation of an intangible described in § 1.263(a)-4 is subject to the rules contained in this section, and not to the rules contained in § 1.263(a)-4. In addition, an amount required to be capitalized by § 1.263(a)-1,