Ruminations on Intangibles

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I don't know if there is a more puzzling overall concept in acquisitions than intangibles. Even avoiding the "goodwill" moniker, I find there is considerable confusion about how to treat acquired intangibles, created intangibles, intangibles acquired from employees and so on. So, focusing on what is admittedly only one segment of the final INDOPCO regulations, let's start with acquired intangibles.

The final INDOPCO regulations were enunciated by T.D. 9107 [IRB 2004-7, 447, Tax Analysts Doc. No. 2004-226, 2004 TNT 7-21]. These regulations are generally effective beginning in 2004. As with the various INDOPCO iterations, they focus on identifying categories of intangibles with respect to which expenditures must be capitalized. In the case of amounts paid to another party to acquire an intangible from that party by purchase (or similar transaction), capitalization is predictably required. And, note that in addition to the purchase price paid for the intangible, any ancillary costs of acquiring the intangible (these would include commissions and attorneys' fees), must also be capitalized [Reg. §1.263(a)-4(c)].

Purchase?

Although we all know what a "purchase" is, a transaction that is "similar" to a purchase is not so clear. Presumably, this obviates the necessity of distinguishing sales from leases, partnership contributions and distributions from disguised sales, and so on. However, the final regulations do not explain the scope of the "similar" transaction rule.

The regulations do give an illustrative list of the types of acquired intangibles to which this rule applies. The regulations illustrate the list of acquired intangibles with:

- ownership interests in entities such as corporation, partnership, trusts, estates or LLCs;
- debt instruments, deposits, stripped bonds and coupons, regular interests in REMICs or FASITs and other intangibles treated as debt for tax purposes;
- financial instruments such as notional principle contracts, foreign currency contracts, options and futures contracts, forward contracts and any other financial derivative;
- endowments or annuity contracts or insurance contracts;
- nonfunctional currencies;
- agreements providing either party with a contract right to use, possess or sell intangibles identified in the foregoing list;
- leases;
- recognized intellectual property rights such as patents, copyrights, franchises, trademarks or trade names;
- assembled work force;
- goodwill or going concern value;

- customer lists;
- servicing rights (such as for a mortgage);
- customer or supplier based intangibles; and
- computer software. [*See* Reg. §1.263(a)-4(c)(1).]

If this list seems exhaustive, it isn't. In fact, the regulations make clear that this is a nonexclusive list.

Before we go on, it is appropriate to pause to contrast the tax treatment of a taxpayer who acquires an intangible from another party, as opposed to self-created intangibles. Obviously, this exhaustive (but nonexclusive) list of intangibles suggests that when we buy an intangible from another, we must capitalize not only the cost of that purchase but also ancillary costs. In contrast, if we develop our *own* intangible (a customer list or patent, let's say), we need not capitalize it.

There is, however, a 12-month rule, so that costs related to intangible rights or benefits of short duration need not be capitalized. This 12-month rule applies only to rights and benefits created by the taxpayer, and not to intangibles acquired by purchase. Thus, even this 12-month rule does not apply to acquired intangibles.

Acquiring from Employees

When a company acquires intangibles from employees, the company presumably makes payment to the employee for the services of creating the intangible. That payment need not be capitalized as long as the payment is treated as compensation for personal services and is includable in the employee's income. This income inclusion may be under either Code Sec. 61 (as regular wages) or under Code Sec. 83 (covering restricted property).

But here's the rub. It is not clear how many payments should be able to be so classified. After all, arguably no payment to acquire an intangible asset can be treated as compensation for personal services (unless it is for "creating" the intangible; more about this topic below).

Payment as compensation would be subject to payroll tax and income tax withholding, whereas a payment for the transfer of an intangible would not be subject to withholding. This would seem to suggest that in the case of intangibles acquired from employees, there would have to be a dual purpose to a payment, and therefore an allocation of the payment for tax purposes.

Created Intangibles

Payments to create or originate intangible assets must be capitalized if they fit into one or more of the following categories:

- financial interests;
- prepaid expenses;
- memberships and privileges;
- rights obtained from a government agency;
- contract rights;
- contract terminations;
- benefits arising from the provision, production or improvement or real property; or
- defense or perfection of title to intangible property.

See Reg. §1.263(a)-4(d).

Each of these eight categories is briefly described below.

Financial Interests

Expenditures must be capitalized if they are made to create, originate, enter into, renew or renegotiate a "financial interest." A financial interest includes an ownership interest in a legal entity (corporation, partnership, LLC, *etc.*); a debt instrument, including any intangible which is treated as debt for federal income tax purposes; a financial interest (letter of credit, credit card agreement, *etc.*); an endowment, annuity or insurance contract with cash value; a nonfunctional currency; and any agreement that provides either party with the right to use, possess or sell a financial interest.

There is a whole host of definitions here, and the regulations go into exhaustive detail about this type of intangible. What constitutes a renegotiation is the subject of special explanation. There are also a number of examples in this portion of the regulations.

Prepaid Expenses

Capitalization is required for prepaid expenses, which simply means amounts that are prepaid for benefits to be received in the future. There is, however, a 12-month rule, under which taxpayers generally need not capitalize amounts that are paid to create an intangible, if the intangible will not confer any right or benefit to the taxpayer for a period of over 12 months, or beyond the end of the next tax year, whichever occurs first. That rule also applies in the case of prepaid expenses.

Memberships and Privileges

Again subject to the 12-month rule, taxpayers are required to capitalize expenditures that are made to obtain, renew, renegotiate or upgrade certain memberships and privileges. There are four examples in this portion of the final regulations. Notably, taxpayers are not required to capitalize amounts that are paid to obtain certification of the taxpayers' products, services or business processes. [*See* Reg. §1.263(a)-4(d)(4)(i).]

Rights Obtained from Government Agencies

Again subject to the 12-month rule, taxpayers must capitalize payments made 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. This would include business licenses that are valid indefinitely, and professional licenses (including bar admission).

Contract Rights

Subject to the 12-month rule, taxpayers must capitalize expenditures related to five categories of contracts, including property leases; service contracts; covenants not to compete; standstill agreements; and annuities, endowments and insurance contracts.

One of the most important categories is covenants not to compete. In an acquisition context, a covenant not to compete oftentimes covers both the performance of services, and *refraining* from the performance of services. An agreement that includes a covenant not to compete that nevertheless requires the performance of some services can be bifurcated, with the amount paid for services actually rendered (and that constitutes reasonable compensation) not required to be capitalized. [*See* Reg. §1.263(a)-4(d)(6)(i)(C).]

There is a *de minimus* exception for the contract right capitalization provision. A taxpayer that makes a payment to another party to create a contract right is not required to capitalize the payment if that payment, when aggregated with all other payments made to the party with respect to the agreement, does not exceed $5,000.

Contract Terminations

Taxpayers must capitalize payments made to terminate three types of agreements: (1) real and tangible property leases in which the taxpayer is the lessor; (2) agreements granting the exclusive right either to acquire or use the taxpayer's property or services, or to conduct the taxpayer's business; and (3) covenants not to compete and other similar agreements.

Provision or Improvement of Real Property

The final regulations state that taxpayers must capitalize the purchase price of real property that is relinquished to another, as well as amounts paid to improve real property owned by another, if the property can reasonably be expected to produce significant economic benefits for the taxpayer.

Defending Title to Intangible Property

Expenses incurred to defend or perfect title to an intangible must be capitalized. Since this has long been the law, there seem to be few controversies here. Of course, there are often indirect costs, and these would be required to be capitalized as well. Strangely enough, the final regulations on defending title to intangible property actually seem to be narrower than the existing case law, in that they expressly cover only payments made directly to those who are challenging the taxpayers' intangible property rights. However, since indirect costs such as legal fees would generally be treated in the same manner, this apparent liberality may be of little practical import.

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