**APPEALS**
**INDUSTRY SPECIALIZATION PROGRAM**
**COORDINATED ISSUE PAPER**

**INDUSTRY:** Food

**ISSUE:** Package Design Costs

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**APPROVED:**

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## ISSUE

Whether package design costs must be capitalized and if so, whether capitalized package design costs may be amortized.

## EXAMINATION DIVISION'S POSITION

Package design costs are capital expenditures within the meaning of Section 263A of the Code, applicable to costs incurred after December 31, 1986, and section 263, applicable to costs incurred prior to January 1,1987. Package design costs are generally not amortizable pursuant to either section 167, relating to amortization of intangible assets, or section 177, relating to the amortization of trademark expenditures.

Since the publication of Revenue Procedure 90-63, 1990-2 C.B. 664, Examination Division has been allowing taxpayers to change their method of accounting for package design costs and elect one of the three alternative accounting methods.

## DISCUSSION

Code Section 263(a) provides that no deduction shall be allowed for any amount paid for permanent improvements made to increase the value of any property or estate. Treasury Regulations Section 1.263(a)-2 provides examples of capital expenditures and includes the costs of acquiring property having a useful life substantially beyond the taxable year.

Section 263A of the Code and regulations thereunder provide for the capitalization of certain direct and indirect costs with respect to real or intangible personal property produced by the taxpayer and certain property acquired for resale.

Temporary Income Tax Regulations Section 1.263A-IT(a)(5)(ii) states that the term "produce" includes construct, build, install, manufacture, develop, improve, create, raise or grow. Although section 263A of the Code does not explicitly require that the production cost of intangible property be capitalized, section 263A(b) defines tangible personal property to include a film, sound recording, video tape, book, or similar property containing

words, ideas, concepts, images or sounds.

The Supreme Court's decision in Indopco, Inc. v. Commissioner, No. 90-1278 (February 26, 1992) held that deductions are exceptions to the norm of capitalization and are allowed only if there is clear provisions for them in the Code and the taxpayer has met the burden of showing a right to the deduction. The Supreme Court pointed out that the presence of incidental future benefits may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is important in determining whether the appropriate tax treatment is immediate deduction or capitalization. Package designs without question benefit a taxpayer beyond the year in which the expenditure is incurred.

Section 167 of the Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion,
wear and tear (including a reasonable allowance for obsolescence)
of property used in the trade or business. Regulations Section 1.167(a)-3 provides that if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. (underscoring provided).

The Internal Revenue Service published Revenue Procedure 90-63,
1990-2 C.B. 664, which provides exclusive procedures for taxpayers changing their method of accounting for package design costs.
This revenue procedure offers taxpayers three alternative methods
of accounting for package design costs; (1) capitalization, (2)
design-by-design capitalization and 60-month amortization, and (3) pool-of-cost capitalization and 48-month amortization.

Section 1.04 of this Revenue Procedure provides that if a taxpayer makes a change in method of accounting for package design costs
without complying with the conditions of this revenue procedure, the taxpayer has made a change in method of accounting without obtaining the consent of the Commissioner as required under section 446(e) of the Code. Therefore, if a taxpayer does not comply with the conditions of Revenue Procedure 90-63, the package design cost will be capitalized without any amortization. Such cost is only deductible when the particular design is abandoned or the year the taxpayer experiences a sudden loss of the design usefulness in its business.

Finally, Code Section 177 for years prior to 1987 provided that
any trademark or trade name expenditure paid or incurred during the taxable year may at the election of the taxpayer be treated as a deferred expense. The expenditures so incurred and treated as a deferred expense shall be allowed as a deduction ratably over such period of not less than 60 months.

Section 177(b) defines the term "trademark or trade name expenditure" as any expenditure which:

(1) is directly connected with the acquisition, protection, expansion, registration (Federal, State or foreign) or defense of a trademark or trade name;

(2) is chargeable to capital account, and

(3) is not part of the consideration paid for a trademark, trade name, or business.

Therefore, if the taxpayer registers the package design with the Commerce Department for protection under the trademark and trade name statutes (The Lanham Act of 1946 as Amended), the cost would be eligible for the special 60 months amortization. The Lanham Act defines trademark to "include any word, name, symbol, or device, or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those sold or manufactured by others". The Act provides for the establishment of two registers, the Principal Register and the Supplemental Register, under which trademarks and trade names can be registered. Coined, arbitrary, fanciful or suggestive marks ("technical marks"), are registered on the Principal Register.

Marks not qualified for the applicants goods may consist of any trademark, symbol, label package, configuration of goods, name, word, slogan, phrase, surname, geographical name, numeral, or device, or any combination of any of the foregoing. Expenses directly connected with the acquisition, protection, expansion, registration, or defense of a trademark or trade name are capital expenditures. These expenditures are not normally depreciable or amortizable because they have indefinite useful lives, but were accorded special treatment under Code section 177.

The Tax Reform Act of 1986 repealed section 177 and therefore the 60 month amortization under section 177 is no longer available to taxpayer for tax years after 1986 unless some limited transitional rules apply.

The Internal Revenue Service issued a Private Letter Ruling 8611005, dated November 26, 1985 in which it determined that package design costs did not qualify for the section 177 amortization afforded trademark and trade name expenditures. Therefore, costs expended for trademark and trade names would not qualify for amortization under Revenue Procedure 90-63 subsequent to the repeal of section 177 of the Code.