APPEALS
TECHNICAL GUIDANCE
SETTLEMENT GUIDELINES

INDUSTRY:	Securities & Financial Services
ISSUE:	Capitalization of Costs to Obtain Management Contracts
COORDINATOR:	Doug Wilke
TELEPHONE NUMBER:	314-612-4658
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/s/ L.P Mahler — Nov. 18, 2004

DIRECTOR, TECHNICAL SERVICES — DATE

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APPEALS SETTLEMENT GUIDELINES
SECURITIES & FINANCIAL SERVICES INDUSTRY
CAPITALIZATION OF COSTS TO OBTAIN MANAGEMENT CONTRACTS

UIL Nos: 162.05-00 AND 263.22-00

STATEMENT OF ISSUES

1. Whether the costs Investment Advisors incur in starting new mutual funds are deductible as ordinary and necessary business expenses under section[1] 162 or must be capitalized under section 263(a).

2. If the costs described in paragraph 1, above, must be capitalized, whether Investment Advisors are entitled to deduct an amortized portion of such costs under section 167.

LARGE AND MID-SIZE BUSINESS DIVISION'S POSITIONS

Issue 1.

The costs incurred by Investment Advisors to create new mutual funds and thereby obtain management contracts are required to be capitalized under section 263(a).

Issue 2.

The costs incurred by Investment Advisors to create new mutual funds may only be amortized if the useful life of the relationship with the mutual fund can be determined, based on historical or industry-wide information.

INDUSTRY/TAXPAYER POSITIONS

Issue 1.

The costs incurred by Investment Advisors to create new mutual funds and thereby obtain management contracts may be deducted under section 162.

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

Issue 2.

To the extent that any costs incurred by Investment Advisors to create new mutual funds have to be capitalized, taxpayers have proposed various amortization periods, all of which are less than 15 years.

DISCUSSION

This revised settlement guideline is based on the fact pattern set forth in the LMSB Division's Coordinated Issue Paper (CIP)[2] issued on March 25, 1994 and updates Appeals settlement guidelines dated March 22, 1996. It reflects the U.S. Tax Court decision in FMR Corp. and Subsidiaries v. Commissioner, 110 T.C. 402 (1998), and the issuance of Treasury Regulation § 1.263(a)-4, TD 9107 effective December 31, 2003.

Mutual funds are regulated investment companies (RICs) whose activities are governed by federal securities law. Mutual funds can be formed as corporations, partnerships, or trusts. The federal tax requirements and treatment of mutual funds are primarily set forth in sections 851 through 855 and the regulations thereunder.

Investment Advisors provide investment management services to mutual funds under a management contract with the mutual fund. From time to time, Investment Advisors, who already manage mutual funds, create new mutual funds. The Investment Advisors incur substantial internal and external costs to create these new mutual funds. These costs typically include expenditures for investment and market research, legal and accounting fees, regulatory costs, and other outlays to organize the mutual funds and bring the funds to market. After formation, the new mutual fund may sometimes reimburse the Investment Advisor for some of these costs. This settlement guideline only applies to unreimbursed costs incurred by Investment Advisors prior to entering into the management contract with the mutual fund.

At the time of the mutual fund's formation, its sole shareholder (or general partner or trustee, as the case may be) generally is an affiliate of the Investment Advisor. Typically, up to sixty percent of the mutual fund's board of directors are employees of the Investment Advisor (or otherwise associated with the Investment Advisor or an affiliate of the Investment Advisor). Because the mutual fund itself has no employees, it enters into contracts with the Investment Advisor, a distributor, and sometimes an administrator. In many cases, the Investment Advisor (or affiliate of the Investment Advisor) also acts as the mutual fund administrator and distributor. Pursuant to these contracts, the Investment Advisor, distributor, and administrator are paid an annual fee based upon an agreed-upon

[2] The CIP was issued by the Internal Revenue Service's Examination Division. Subsequent to the issuance of the CIP, the Internal Revenue Service has been reorganized into several operating divisions, including the Large and Mid-Size Business (LMSB) Division. LMSB's Office of Pre-Filing & Technical Guidance now has jurisdiction over the CIP.

percentage of the mutual fund's annual net assets. The agreed-upon percentage is subject to certain regulatory limitations.

The management contract between the Investment Advisor and the mutual fund determines the advisor's responsibilities with respect to the management of the mutual fund assets. It also specifies the compensation the Investment Advisor is entitled to receive. This compensation ordinarily varies from 0.5 percent to 0.75 percent of the average net assets of the fund each year.

Beginning with the development of the idea for the new mutual fund, the Investment Advisor will typically incur costs for the development of the initial marketing plan, drafting of the management contract, formation of the mutual fund, obtaining the board of trustees' approval of the contract, and registering the new mutual fund with the SEC and the various States in which the mutual fund will be marketed. This series of activities continues up to the point when each new mutual fund has been effectively registered with the SEC but before shares in the new Mutual Fund are actually offered to the public.

When creating a new mutual fund, an Investment Advisor risks its capital in the venture because, as the founder of the fund, the Investment Advisor expects to be awarded the fund's initial management contract and to have that contract periodically renewed. After a mutual fund is created, it is owned by those who invest in the mutual fund, and the mutual fund's activities are controlled by an independent board of directors elected by the mutual fund's investors. Although the terms of a management contract, and any renewal thereof, must be approved by a majority vote of the mutual fund's independent directors, it is extremely rare for a management contract to be terminated or not to be renewed. Thus, a mutual fund's management contract with an Investment Advisor generally remains in force as long as a particular fund remains in operation. If, however, a particular fund fails in its early years, the contract terminates and the Investment Advisor suffers an economic loss.

Law and Analysis:

Issue 1.

Section 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." To qualify as an allowable deduction under section 162(a), an item must: (1) be paid or incurred during the taxable year; (2) be for carrying on any trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. Commissioner v. Lincoln Savings & Loan Association 403 U.S. 345, 352 (1971).

The issue in the CIP and this settlement guideline is whether the costs incurred in starting new mutual funds are "ordinary expenses" capable of deduction under section 162(a). The principal function of the term "ordinary" in section 162(a) is to clarify the distinction between

those expenses that are currently deductible and those expenses that are capital in nature, which, if deductible at all, must be amortized over the useful life of the asset. Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966). Section 263(a) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property. That is, a capital expense is not an ordinary expense within the meaning of section 162(a) and is therefore not currently deductible. Lincoln Savings & Loan Assn, 403 U.S. at 353.

Lincoln Savings stands for the simple proposition that a taxpayer expenditure that "serves to create or enhance a separate and distinct" asset should be capitalized under section 263(a). INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 86 (1992); See also Treas. Reg. §1.263(a). The CIP holds that the mutual fund start-up costs create an asset and therefore must be capitalized. Under the CIP's rationale, the Investment Advisor makes expenditures that result in the creation of a mutual fund. As the mutual fund's founder, the Investment Advisor expects to be awarded the initial contract to manage the new fund, as well as the annual renewals of the management contract for as long as the mutual fund exists. The management contract embodies the Investment Advisor's management relationship with the new fund, i.e., the right to provide fund management services in exchange for remuneration. The CIP concludes that this relationship is a separate and distinct asset with an expected life of more than one year.

An expenditure that creates or enhances a separate and distinct asset is capital. However, the existence of a separate and distinct asset is not necessary in order to classify an expense as capital in nature. In INDOPCO, the Supreme Court concluded that certain legal and professional fees incurred by a target corporation to facilitate a friendly acquisition were capital expenditures, even though these expenses did not create a separate and distinct asset. In reaching this decision, the Court specifically rejected the argument that its decision in Lincoln Savings should be read as holding "that only expenditures that create or enhance separate and distinct assets are to be capitalized under section 263." INDOPCO, 503 U.S. at 86, 87. The Court held that the acquisition costs created significant long-term benefits for the taxpayer. Thus, Lincoln Savings and INDOPCO require taxpayers to capitalize costs that either create or enhance an asset or costs that create significant long term benefit to the taxpayer.

Subsequent to the issuance of the CIP, facts similar to those set forth in the CIP were the subject of the Tax Court decision in FMR Corp. and Subsidiaries v. Commissioner, 110 T.C. 402 (1998). In FMR Corp., the Tax Court required capitalization of costs to develop and launch mutual funds solely on the basis of the INDOPCO future benefits principle. The Tax Court declined to find that mutual fund start up costs created a separate and distinct asset. The Court reasoned that the costs incurred in starting new mutual funds provided the taxpayer with significant future benefits beyond the tax year in which the costs were incurred. The significant future benefits included the initial contract to manage the new mutual fund, the annual renewals of that contract for as long as the mutual fund exists, and synergistic benefits produced to the Investment Advisor's entire

family of funds. Thus, even if the mutual fund start-up costs do not create a separate and distinct asset, the INDOPCO rationale still may require an Investment Advisor to capitalize expenditures it incurred to create a new mutual fund. FMR Corp., 110 T.C. 402.

Issue 2.

Section 167 provides a depreciation or amortization deduction for the exhaustion of property used in a trade or business or held for the production of income. In order to be eligible for amortization under section 167, an intangible asset or benefit must have a limited useful life the length of which can be estimated with reasonable accuracy**.** See Treas. Reg. §1.167(a)-2; Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993). Thus, the capitalized costs of creating a new mutual fund may be amortized only if the useful life of the relationship with the fund can be determined, based on historical or industry-wide information.

SETTLEMENT GUIDELINES

Issue 1.

The settlement of what mutual fund start-up costs must be capitalized, if any, requires the identification and segregation of the various costs incurred in launching a new mutual fund. Based on the hazards of litigation analysis set forth below, the Appeals Settlement Guidelines are:

- An Investment Advisor does not have to capitalize employee compensation (including bonuses and commissions), overhead, advertising or external promotion costs, and de minimis costs associated with the start-up of a new mutual fund.

- An Investment Advisor must capitalize the remaining costs associated with the start-up of a new mutual fund. These costs typically include, but are not limited to, filing fees and external legal fees.

Based on the Tax Court's decision in FMR Corp., the hazards of litigation with respect to the capitalization issue (whether the start-up expenses incurred by an Investment Advisor must be capitalized) appear minimal. The FMR Tax Court decision fully supported the Service position that costs to launch mutual funds should be capitalized since they produced future benefits through the management contracts obtained with the new funds.

However, subsequent litigation indicates that the future benefits standard of INDOPCO, the basis of FMR Corp., has proven to be difficult to articulate and apply. In particular, the

Third and Eighth Circuit Courts of Appeals, have rejected a broad interpretation of the capitalization requirement. This has led to continued uncertainty and controversy between taxpayers and the Internal Revenue Service (IRS).

In PNC Bancorp v. Commissioner, 212 F.3rd 822 (3rd Cir. 2000), rev'g 110 T.C. 349 (1998), the Third Circuit reversed the Tax Court decision and found that loan origination expenses incurred by the bank for marketing, researching and originating loans were not capital expenditures but deductible as ordinary and necessary business expenses under section 162. The costs included both external costs for payments to third parties for credit screening, property reports and appraisals and internal costs for a portion of employee salaries and benefits that could be attributed to time spent completing and reviewing loan applications. The decision emphasized that the loan marketing expenses were recurring and routine day-to-day costs of the bank and better fit under the ordinary and necessary language of section 162 rather than the permanent improvements or betterments language of section 263(a).

In Wells Fargo & Company v. Commissioner, 224 F.3d 874 (8th Cir. 2000), the Eighth Circuit reversed the Tax Court's decision in Norwest Corp. v. Commissioner, 112 T.C. 89 (1999). In that case, the issue was whether officers' salaries which were related to a merger transaction were allowable as a current deduction or were they required to be capitalized. The Tax Court found that the costs must be capitalized because they were "sufficiently related" to the merger transaction, an event that produced a significant long-term benefit. The Eighth Circuit disagreed and found that the salaries would have been incurred regardless of the merger issue and that the salaries originated from the employment relationship and not because of the capital project.

The Tax Court distinguished between deductible expenses and non-deductible expenses in D.J. Lychuk v. Commissioner, 116 T.C. 374 (2001). In that case the costs at issue were wages and bonuses paid to employees who performed routine investigatory services for their employer in its business of acquiring installment contracts from automobile dealers. In addition, other overhead expenses such as printing, telephone, computer, rent and utilities were paid. The court found the employee wages and bonuses to be directly related to the acquisition of the installment contracts and thus should be capitalized rather than deducted. These expenses were such an integral part of the "acquisition process" that they must be considered as part of the cost of the installment contracts. In contrast, the Tax Court found capitalization not required for overhead costs allocable to the taxpayer's acquisition of installment loans because the overhead did not originate in the process of acquiring the installment notes, and would have been incurred even if the taxpayer did not engage in such acquisition. The overhead expenses were held to be routine and recurring expenses which had no meaningful relationship to the credit applications analyzed or the number of installment contracts acquired. Any future benefit derived from the overhead expenses was merely incidental to their underlying cost.

In an attempt to resolve the continuing uncertainty and controversy concerning

capitalization, the Treasury and the IRS have issued guidance. First, the Office of Chief Counsel issued Notice CC-2002-021 on March 15, 2002. The Notice announces a "Change in Litigating Position" regarding capitalization under section 263(a) of transaction costs related to the acquisition, creation or enhancement of intangible assets or benefits. The Notice advises that the Service will not assert capitalization for employee compensation (other than bonuses or commissions that are paid with respect to the transaction), fixed overhead expenses or de minimis costs related to the acquisition, creation, or enhancement of intangible assets or benefits. For the purposes of the Notice, costs are considered de minimis to the extent they do not exceed $5,000 for each transaction.

In December 2002, the Treasury and IRS issued proposed Treasury Regulations §1.263(a)-4 (REG-125638-01) on the capitalization of costs for intangible assets. These proposed regulations require the capitalization of amounts paid to acquire, create, or enhance an intangible asset. An intangible asset includes a future benefit that the IRS and Treasury identify in subsequent published guidance as an intangible asset for which capitalization is required.

In December, 2003, the Treasury and IRS issued final regulations under § 1.263(a)-4 (RIN 1545-BA00). The final regulations under § 1.263(a)-4 apply to amounts paid or incurred on or after December 31, 2003. Treasury Regulation 1.263(a)-4 retains the rules set forth in proposed Treasury Regulations §1.263(a)(4) (REG-125638-01), which require capitalization of amounts paid to acquire or create intangibles and amounts to facilitate the acquisition or creation of intangibles.

Except as otherwise provided in Treasury Regulation § 1.263(a)-4, a taxpayer must capitalize an amount paid to create an intangible. Treas. Reg. § 1.263(a)-4(b)(ii). Treasury Regulation §1.263(a)-4(e)(4)(i) provides the simplifying assumption that employee compensation (including salary, bonus and commissions), overhead costs and de minimis costs do not facilitate the acquisition, creation or enhancement of an intangible asset and are, therefore, not required to be capitalized. The term employee compensation means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. Treas. Reg. § 1.263(a)-4(e)(4)(ii)(A). Whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations contained thereunder. Id.

Treasury Regulation §1.263(a)-4(e)(4)(iii)(A) provides that the term de minimis costs means those amounts that are paid with respect to a transaction if, in the aggregate, the amounts do not exceed $5,000. If the amount paid by the Investment Advisor exceeds $5,000, then no portion of the amounts paid by the Investment Advisor are currently deductible as de minimis costs. In determining the amount of transaction costs paid with respect to a transaction, a taxpayer generally must account for the actual costs paid with respect to the transaction. However, a taxpayer that reasonably expects to enter into at least 25 similar transactions, may elect to determine the amount of transaction costs paid

with respect to a transaction using the average cost pooling method. See Treas. Reg. §§ 1.263(a)-4(e)(4)(iii)(A) and 1.263(a)-4(h).

Treasury Regulation § 1.263(a)-4(f)(1) has a "12-month rule". Under this rule, a taxpayer is not required to capitalize 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.

The 12-month rule does not apply to amounts paid to create or enhance a financial interest. Treas. Reg. § 1.263-4(f)(3).3/

Clearly the trend is for a reduction of the burden on both taxpayers and the IRS in identifying whether an expense is one that requires capitalization. Due to the elimination of many of the internal costs for employee compensation and overhead in the regulations, it is

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3/ Under Treasury Regulation § 1.263-4(d)(2)(i) a "financial interest" includes:

(A) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other similar 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 instruments 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)); (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)); and (8) Any other financial derivative.

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

(E) Non-functional currency.

expected that the amount of the expense adjustments at issue will be greatly diminished in the future.

Accordingly, the settlement of the capitalization issue (Issue 1.) involves a factual determination of the amount to be capitalized. An Investment Advisor does not have to capitalize employee compensation (including bonuses and commissions), overhead, advertising or external promotion costs, and de minimis costs associated with the start-up of a new mutual fund. The investment Advisor must capitalize the remaining costs associated with the start-up of a new mutual fund. The ultimate settlement of the capitalization issue will depend on how well the case is developed in identifying the specific costs, the application of the new directives and regulations, and the facts of each case.

Issue 2.

Based on the analysis set forth below, the Appeals Settlement Guidelines are:

- The capitalized costs associated with the starting up a new mutual fund (i.e., the cost the Investment Advisor must capitalize when creating a new mutual fund), should be amortized over a 15-year period.

The second issue is whether the capitalized amounts may be amortized. With respect to this issue, the industry has argued that if costs to obtain the management contract must be capitalized, such costs should be amortized over a two or three-year period. The rationale for this argument is based on the indication that the initial contracts generally are for 2 years and thereafter, subject to annual renewal. Typically the contracts also contain a 60-day termination clause.

With respect to the amortization period, industry practice indicates that it is rare for a management contract to be terminated or not to be renewed. A study of information secured from CDA Wiesenberger of CDA Investment Technologies, Inc. of 5,760 mutual funds revealed that only 60 (1.042%) of the funds in the study liquidated on an average of four years. This small percentage indicates that it is rare for a management contract to be terminated.

In FMR Corp., the taxpayer argued that the costs incurred were deductible as expansion costs to maintain and promote its investment management business by obtaining new management contracts with the new funds. Alternatively, the taxpayer argued that the costs were start-up expenditures incurred in investigating and/or creating an active trade or business which, at the taxpayer's election, could be amortized over a period of not less than 60 months under section 195. The Court observed that the future benefits standard of INDOPCO carried greater weight than classifying an expense as an expansion cost or start-up expense. Further, any start-up expense had to meet the requirement that the expense would be deductible if paid or incurred in connection with the current operation of

an existing active trade or business. Therefore, neither of the taxpayer's arguments prevailed in the Tax Court's decision.

In December 2003, the Treasury and IRS issued Treasury Regulation § 1.167(a)-3(b) (RIN 1545-BA00), which provides a safe harbor amortization for certain intangibles. Under Treasury Regulation § 1.167(a)-3(b), a taxpayer may treat an intangible asset as having a useful life of 15 years. There are exceptions to this safe harbor, but they do not apply to created intangibles, such as the management contracts. Therefore, we propose that the costs to obtain management contracts be amortized over 15 years.

If you have any questions with respect to this document, please contact Appeals Officer Doug Wilke at 314-612-4658.