

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2004-3, page 486.

Service partnerships. This ruling provides guidance concerning the application of the U.S.-Germany income tax treaty to a nonresident partner in a service partnership that conducts activities in the United States. It makes clear that a nonresident partner is subject to U.S. income tax on his share of income from the partnership to the extent that such income is attributable to the partnership's activities in the United States, without regard to whether the partner performs services in the United States. This ruling also applies to other U.S. income tax treaties that have the same or similar provisions as those in the U.S.-Germany treaty.

T.D. 9107, page 447.

Final regulations under section 263(a) of the Code provide rules for applying section 263(a) to amounts paid to acquire or create intangibles. These regulations also provide rules for applying section 263(a) to amounts paid to facilitate the acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. In addition, these regulations provide safe harbor amortization under section 167(a) for certain intangibles and explain the manner in which taxpayers may deduct debt issuance costs.

Notice 2004-5, page 489.

Pursuant to the authority granted under section 772(a)(11) of the Code, the Secretary has determined that it is appropriate for a partner of an electing large partnership to take into account separately the partner's distributive share of the partnership's dividends received that are qualified dividend income as defined in section 1(h)(11)(B). This requirement is effective for dividends received by a partnership after December 31, 2002.

EMPLOYEE PLANS

Rev. Rul. 2004-10, page 484.

Significant detriment; defined contribution plan; allocation of expenses. This ruling describes the application of the significant detriment rule in regulations section 1.411(a)-11(c)(2)(i) in relationship to the Department of Labor's Field Assistance Bulletin 2003-3 pertaining to the allocation of expenses in a defined contribution plan.

Rev. Rul. 2004-11, page 480.

Coverage; special rules; request for comments. This ruling describes the application of the special coverage rule for acquisitions and dispositions in section 410(b)(6)(C) of the Code in a situation involving a defined benefit plan and a profit-sharing plan that includes a qualified cash or deferred arrangement under section 401(k)(2). In addition, the ruling holds that a significant change in a plan or in the coverage of a plan during the transition period under section 410(b)(6)(C)(ii) curtails the period effective as of the date of the change and does not make the plan retroactively ineligible to apply section 410(b)(6)(C). Finally, the ruling also asks for comments as to other situations that may arise under section 410(b)(6)(C).

Rev. Rul. 2004-12, page 478.

Plan qualification; rollovers. This ruling describes a situation where an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan. As a result, distributions of those amounts are not subject to the restrictions on permissible timing that apply, under the applicable requirements of the Code, to distributions of other amounts from the plan.

(Continued on the next page)

Announcements of Disbarments and Suspensions begin on page 499.
Finding Lists begin on page ii.



Rev. Rul. 2004–13, page 485.

Top-heavy status; special rules. This ruling describes four situations where a non-governmental profit-sharing plan contains a cash or deferred arrangement described in section 401(k) of the Code that provides for safe harbor matching contributions. In the first situation, the ruling holds that the requirements of section 416(g)(4)(H) are met for that year. In the other situations, the ruling holds that the contributions do not meet the requirements of section 416(g)(4)(H).

Rev. Proc. 2004–14, page 489.

This document provides procedures under which a corporation's S status will not be terminated by a direct rollover of stock from its employee stock ownership plan (ESOP) to a participant's individual retirement account (IRA). Rev. Proc. 2003–23 modified and superseded.

Rev. Proc. 2004–15, page 490.

Minimum funding standards; waivers. This procedure sets forth guidelines for requesting waivers of the minimum funding standards with respect to defined benefit and defined contribution plans subject to section 412 of the Code. Rev. Procs. 2004–4, 2004–5, 2004–6 modified. Rev. Proc. 94–41 superseded.

TAX CONVENTIONS

Rev. Rul. 2004–3, page 486.

Service partnerships. This ruling provides guidance concerning the application of the U.S.-Germany income tax treaty to a nonresident partner in a service partnership that conducts activities in the United States. It makes clear that a nonresident partner is subject to U.S. income tax on his share of income from the partnership to the extent that such income is attributable to the partnership's activities in the United States, without regard to whether the partner performs services in the United States. This ruling also applies to other U.S. income tax treaties that have the same or similar provisions as those in the U.S.-Germany treaty.

ADMINISTRATIVE

Rev. Proc. 2004–14, page 489.

This document provides procedures under which a corporation's S status will not be terminated by a direct rollover of stock from its employee stock ownership plan (ESOP) to a participant's individual retirement account (IRA). Rev. Proc. 2003–23 modified and superseded.

Announcement 2004–10, page 501.

This document contains corrections to final and temporary regulations (T.D. 9048, 2003–1 C.B. 644) under section 1502 of the Code that redetermine the basis of stock of a subsidiary member of a consolidated group immediately prior to certain transfers of such stock and certain deconsolidations of a subsidiary member and also suspend certain losses recognized on the disposition of stock of a subsidiary member.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by

applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.*

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* **Beginning with Internal Revenue Bulletin 2003-43**, we are publishing the index at the end of the month, rather than at the beginning.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 263.—Capital Expenditures

26 CFR 1.263(a)-1: Capital expenditures; in general.

T.D. 9107

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Guidance Regarding Deduction and Capitalization of Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that explain how section 263(a) of the Internal Revenue Code (Code) applies to amounts paid to acquire or create intangibles. This document also contains final regulations under section 167 of the Code that provide safe harbor amortization for certain intangibles, and final regulations under section 446 of the Code that explain the manner in which taxpayers may deduct debt issuance costs.

DATES: *Effective Date:* These regulations are effective December 31, 2003.

Applicability Date: For dates of applicability of the final regulations, see §§1.167(a)-3(b)(4), 1.263(a)-4(o), 1.263(a)-5(m), and 1.446-5(d).

FOR FURTHER INFORMATION CONTACT: Andrew J. Keyso, (202) 622-4800 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this final rule has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545-1870.

The collection of information in this regulation is in §1.263(a)-5(f). This information is required to verify the proper allocation of certain amounts paid in the process of investigating or otherwise pursuing certain transactions involving the acquisition of a trade or business. The collection of information is voluntary and is required to obtain a benefit. The likely recordkeepers are business entities.

Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by March 5, 2004. Comments are specifically requested concerning:

Whether the collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

Estimated total annual recordkeeping burden: 3,000 hours.

Estimated average annual burden hours per recordkeeper: 1 hour.

Estimated number of recordkeepers: 3,000.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On January 24, 2002, the IRS and Treasury Department published an advance notice of proposed rulemaking in the **Federal Register** (REG-125638-01, published in the Bulletin as Announcement 2002-9, 2002-1 C.B. 536 [67 FR 3461]) announcing an intention to provide guidance on the extent to which section 263(a) of the Internal Revenue Code (Code) requires taxpayers to capitalize amounts paid to acquire, create, or enhance intangible assets. A notice of proposed rulemaking was published in the **Federal Register** (REG-125638-01, 2003-1 C.B. 373 [67 FR 77701]) on December 19, 2002, proposing regulations under section 263(a) (relating to the capitalization requirement), section 167 (relating to safe harbor amortization) and section 446 (relating to the allocation of debt issuance costs). A public hearing was held on April 22, 2003. In addition, written comments responding to the notice of proposed rulemaking were received. After consideration of all of the public comments, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed below.

Explanation of Provisions

I. Format of the Final Regulations

The final regulations modify the format of the proposed regulations. The final regulations retain in §1.263(a)-4 the rules requiring capitalization of amounts paid to acquire or create intangibles and amounts paid to facilitate the acquisition or creation of intangibles. However, the rules requiring capitalization of amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions are contained in a new §1.263(a)-5. Dividing

the rules into two sections enabled the IRS and Treasury Department to apply some of the simplifying conventions in the proposed regulations to certain acquisitions of tangible assets in §1.263(a)-5, while limiting the application of §1.263(a)-4 to costs of acquiring and creating intangibles. The format of the final regulations contained in §§1.446-5 and 1.167(a)-3 is essentially unchanged from the format of the proposed version of these regulations.

II. *Explanation and Summary of Comments Concerning §1.263(a)-4*

A. *General principle of capitalization*

The final regulations identify categories of intangibles for which capitalization is required. As in the proposed regulations, the final regulations provide that an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure. If the IRS publishes guidance requiring capitalization of an expenditure that produces future benefits for the taxpayer, such guidance will apply prospectively. While most commentators support this approach, some commentators expressed concerns that this approach, particularly the prospective nature of future guidance, will permit taxpayers to deduct expenditures that should properly be capitalized. The IRS and Treasury Department continue to believe that the capitalization principles in the regulations strike an appropriate balance between the capitalization provisions of the Code and the ability of taxpayers and IRS personnel to administer the law, and are a reasonable means of enforcing the requirements of section 263(a).

The final regulations change the general principle of capitalization in three respects from the proposed regulations. First, §1.263(a)-4 of the final regulations does not include the rule requiring capitalization of amounts paid to facilitate a “restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.” As noted above, the rules requiring

taxpayers to capitalize amounts paid to facilitate these types of transactions are now contained in §1.263(a)-5.

Second, the final regulations eliminate the word “enhance” from portions of the general principle. Commentators expressed concerns that the use of the term “enhance” would require capitalization in unintended circumstances. For example, if a taxpayer acquires goodwill as part of the acquisition of a trade or business, future expenditures to maintain the reputation of the trade or business arguably could constitute amounts paid to “enhance” the acquired goodwill. The final regulations remove the word “enhance” in favor of more specifically identifying the types of enhancement for which capitalization is appropriate. For example, the final regulations modify the proposed regulations to provide that a taxpayer must capitalize an amount paid to “upgrade” its rights under a membership or a right granted by a government agency.

Third, the final regulations eliminate the use of, and the definition of, the term “intangible asset” that was contained in the proposed regulations. This change was made in an effort to aid readability. The final regulations simply identify categories of “intangibles” for which amounts are required to be capitalized.

The final regulations clarify that nothing in §1.263(a)-4 changes the treatment of an amount that is specifically provided for under any other provision of the Code (other than section 162(a) or 212) or regulations thereunder. Thus, where another section of the Code (or regulations under that section) prescribes a specific treatment of an amount, the provisions of that section apply and not the rules contained in these final regulations. For example, where the treatment of an insurance company’s policy acquisition expenses is prescribed by sections 848 and 197(f)(5) of the Code, those sections apply and not these final regulations. Similarly, capitalization is not required under the final regulations for expenditures that are deductible under section 174.

The general definition of a separate and distinct intangible asset in paragraph (b)(3) of the final regulations is unchanged from the proposed regulations, except to clarify that a separate and distinct intangible asset must be intrinsically capable of being sold, transferred, or pledged (ignoring any re-

strictions imposed on assignability) separate and apart from a trade or business. The final regulations also clarify that a fund is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund may revert to the taxpayer.

In addition, the application of the separate and distinct intangible asset definition to specific intangibles has been further limited in the final regulations. The final regulations provide that an amount paid to create a package design, computer software or an income stream from the performance of services under a contract is not treated as an amount that creates a separate and distinct intangible asset. For a further discussion of issues pertaining to computer software, see the discussion in Part II.H. of this Preamble titled “Computer software issues.” In addition, examples are added to paragraph (l) of the final regulations to clarify that product launch costs and stock-lifting costs do not create a separate and distinct intangible asset.

B. *Clear reflection of income*

Commentators questioned how the regulations interact with the clear reflection of income requirement of section 446(b) and whether the IRS would argue that an expenditure that is not required to be capitalized by the regulations should nonetheless be capitalized on the ground that deduction of the expenditure does not clearly reflect income under section 446. If an amount paid to acquire or create an intangible is not required to be capitalized by another provision of the Code or regulations thereunder or by the final regulations or in subsequent published guidance, the IRS will not argue that the clear reflection of income requirement of section 446(b) and the regulations thereunder necessitates capitalization.

C. *Intangibles acquired from another*

The final regulations retain the requirement of the proposed regulations that a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Like the proposed regulations, the final regulations provide a nonexclusive list of intangibles for which capitalization is required. To further clarify that the list is illustrative, the final regulations modify the introductory language to specifically

state that the list contains “examples” of intangibles within the scope of paragraph (c).

D. Created intangibles

1. In General

The final regulations retain the eight categories of created intangibles contained in the proposed regulations. As discussed above, the final regulations eliminate the term “enhance” from the general principle. Instead, as described below, several of the categories of created intangibles are revised to more specifically identify the types of enhancements for which capitalization is required.

A commentator noted that the approach adopted in the regulations of defining categories of intangibles may be subject to abuse if taxpayers seek to deduct expenditures based on immaterial distinctions between those expenditures and expenditures included in the listed categories. To address this concern, the final regulations contain a rule providing that the determination of whether an amount is paid to create an intangible identified in the final regulations is made based on all of the facts and circumstances, disregarding distinctions between the labels used in the regulations to describe the intangible and the labels used by the taxpayer and other parties to describe the transaction. The IRS and Treasury Department intend to construe broadly the categories of intangibles identified in the regulations in response to any narrow technical arguments that an intangible created by the taxpayer is not literally described in the categories. For example, a taxpayer that obtains what is, in substance, a membership in an organization cannot avoid capitalization under paragraph (d)(4) of the final regulations by arguing that the right is titled an “admission” or that the right explicitly provides the taxpayer a “participation right” but not a membership.

2. Financial Interests

The final regulations require taxpayers to capitalize an amount paid to another party to create, originate, enter into, renew or renegotiate with that party certain financial interests. The final regulations retain the categories of financial interests

contained in the proposed regulations, with minor modifications.

The final regulations eliminate the rule contained in paragraph (d)(2)(ii) of the proposed regulations providing that capitalization is not required for an amount paid to create or originate an option or forward contract if the amount is allocable to property required to be provided or acquired by the taxpayer prior to the end of the taxable year in which the amount is paid. This rule was unnecessary and was incorrectly read by some commentators to suggest that taxpayers could immediately deduct amounts paid to create or originate an option or forward contract. The final regulations clarify the treatment of these amounts.

3. Prepaid Expenses

The final regulations retain the rule contained in the proposed regulations. The reference to “benefits to be received in the future” has been deleted to avoid any implication of a “significant future benefits” test. No comments were received suggesting changes to the rule.

4. Certain Memberships and Privileges

The final regulations retain the rule contained in the proposed regulations, but clarify that capitalization also is required if a taxpayer renegotiates or upgrades a membership or privilege. The final regulations also modify an example contained in the proposed regulations that does not address the implications of section 274(a)(3) and unintentionally implies that an amount paid to obtain membership in a social club is required to be capitalized under the regulations. The revised example addresses an amount paid to obtain a membership in a trade association.

5. Certain Rights Obtained From a Governmental Agency

The final regulations retain the rule contained in the proposed regulations, but clarify that capitalization also is required if a taxpayer renegotiates or upgrades its rights. For example, a holder of a business license that pays an amount to upgrade its license, enabling it to sell additional types of products or services, must capitalize that amount.

Several commentators questioned whether an amount paid to a government agency to obtain a patent from that agency is required to be capitalized under this rule if section 174 applies to the amount. As previously discussed, the regulations do not affect the treatment of an expenditure under other provisions of the Code. Accordingly, an amount paid to a government agency to obtain a patent from that agency is not required to be capitalized under the final regulations if the amount is deductible under section 174.

6. Certain Contract Rights

The final regulations retain the rules contained in the proposed regulations regarding capitalization of amounts paid to enter into certain agreements. In addition, the final regulations clarify that taxpayers must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate with that party an agreement not to acquire additional ownership interests in the taxpayer (*i.e.*, a standstill agreement). The IRS and Treasury Department believe that the benefits obtained by the taxpayer from a standstill agreement are similar to the benefits that result from other agreements identified in the rule and that capitalization is therefore appropriate. The rule does not apply to a standstill agreement governed by another provision of the Code, such as section 162(k). An example has been added to the final regulations to illustrate the application of this rule. The final regulations also clarify that a taxpayer must capitalize costs that facilitate the creation of an annuity, endowment contract or insurance contract that does not have or provide for cash value (*e.g.*, a comprehensive liability policy or a property and casualty policy) if the taxpayer is the covered party under the contract.

The final regulations add three rules to address public comments that capitalization is not appropriate if the taxpayer has only a hope or expectation that a customer or supplier will begin or continue a business relationship with the taxpayer. First, the final regulations provide that amounts paid with the mere hope or expectation of developing or maintaining a business relationship are not required to be capitalized, provided the amount is not contingent on the origination, renewal or renegotiation of an agreement. The IRS and Treas-

surey Department believe that amounts that are contingent on the origination, renewal or renegotiation of an agreement are properly capitalized as amounts paid to originate, renew or renegotiate the agreement. Second, the final regulations provide that an agreement does not provide a “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 party to request or pay for the taxpayer’s services. Third, the final regulations provide that an agreement that may be terminated at will by the other party (or parties) to the agreement prior to the expiration of the period prescribed by the “12-month rule” does not constitute an agreement providing the taxpayer the right to use property or provide (or receive) services. However, where the other party (or parties) to the agreement is economically compelled not to terminate the agreement prior to the expiration of the period prescribed by the “12-month rule” in the regulations, then the agreement is not considered to be an agreement that may be terminated at will. Several examples are added to the final regulations to illustrate the application of these rules.

The final regulations also clarify the meaning of “renegotiate.” Under the final regulations, a taxpayer is treated as renegotiating an agreement if the terms of the agreement are modified. In addition, a taxpayer 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 agreement of the other party (or parties), and the other party (or parties) would not have agreed to the cancellation unless the taxpayer entered into the new agreement. See *U.S. Bancorp v. Commissioner*, 111 T.C. 231 (1998).

The final regulations retain the \$5,000 *de minimis* rule contained in the proposed regulations. In addition, the final regulations provide that, if an amount is paid in the form of property, the property is valued at its fair market value at the time of the payment for purposes of determining whether the *de minimis* rule applies. The final regulations also retain the pooling method for *de minimis* costs of creating similar agreements. See Part II.G. of this Preamble titled “Safe harbor pooling

methods” for a further explanation of rules pertaining to pooling.

7. Certain Contract Terminations

The final regulations retain the rule contained in the proposed regulations. No comments were received suggesting changes to the rule. The final regulations, however, clarify that the contract termination provisions do not apply to amounts paid to terminate a transaction subject to §1.263(a)-5. See Part III of this Preamble (“Explanation and Summary of Comments Concerning §1.263(a)-5”) for a discussion of the treatment of amounts paid to terminate a transaction described in §1.263(a)-5.

8. Benefits Arising From the Provision, Production, or Improvement of Real Property

The final regulations retain the rule contained in the proposed regulations, but clarify that the exceptions to the rule apply only to the extent the taxpayer receives fair market value consideration for the real property.

9. Defense or Perfection of Title to Intangible Property

The final regulations retain the rule contained in the proposed regulations. No comments were received suggesting changes to the rule. The final regulations clarify that amounts paid to another party to terminate an agreement permitting that party to purchase the taxpayer’s intangible property or to terminate a transaction described in §1.263(a)-5 are not treated as amounts paid to defend or perfect title. See Part III of this Preamble (“Explanation and Summary of Comments Concerning §1.263(a)-5”) for a discussion of the treatment of amounts paid to terminate a transaction described in §1.263(a)-5.

E. Transaction costs

1. In General

The final regulations require taxpayers to capitalize amounts that facilitate the acquisition or creation of an intangible. The proposed regulations provide that an amount facilitates a transaction if it is paid “in the process of pursuing the transaction.” Some commentators questioned

whether amounts paid to investigate a transaction constitute amounts paid in the process of pursuing the transaction. The IRS and Treasury Department believe that it is inappropriate to distinguish amounts paid to investigate the acquisition or creation of an intangible from other amounts paid in the process of acquiring or creating an intangible. To clarify that investigatory costs are within the scope of the rule, the final regulations provide that amounts facilitate a transaction if they are paid in the process of “investigating or otherwise pursuing the transaction.” In addition, the final regulations clarify that 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.

The proposed regulations provide that, 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 “not relevant.” The IRS and Treasury Department believe that the fact that the amount would or would not have been paid “but for” the transaction is a relevant factor, but not the only factor, to be considered. Accordingly, the final regulations revise this rule to provide that the fact that the amount would (or would not) have been paid “but for” the transaction is a relevant but not a “determinative” factor.

The final regulations eliminate the rule in the proposed regulations that treats amounts paid to terminate (or facilitate the termination of) an existing agreement as facilitating another transaction that is expressly conditioned on the termination of the agreement. The IRS and Treasury Department decided that well advised taxpayers could easily avoid the rule by using general representations, while uninformed taxpayers inadvertently could be caught by the rule. The IRS and the Treasury Department considered replacing the “expressly conditioned” rule with a “mutually exclusive” rule similar to the one contained in §1.263(a)-5 (see Part III of this Preamble). A mutually exclusive rule was not adopted in §1.263(a)-4 because such a rule could have been interpreted as requiring capitalization of contract termination costs that historically have been deductible (for example, an amount paid to terminate a burdensome supply contract if the taxpayer enters into a new supply contract

(for which capitalization is required under the regulations) with another party if the taxpayer could not contract with both parties). A mutually exclusive rule also was not adopted in the final regulations because it would have been administratively difficult to apply such a rule in the context of ordinary business transactions. Instead, §1.263(a)-4 of the final regulations provides that an amount paid to terminate (or facilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement.

Commentators expressed concern that the rules in the proposed regulations requiring taxpayers to capitalize amounts paid in the process of pursuing certain agreements could be interpreted very broadly to require taxpayers to capitalize amounts that should be treated as deductible costs of sustaining or expanding the taxpayer's business. To address this concern, the final regulations add a rule providing that an amount is treated as not paid in the process of investigating or otherwise pursuing the creation of a contract right if the amount relates to activities performed before the earlier of the date the taxpayer begins preparing its bid for the contract or the date the taxpayer begins discussing or negotiating the contract with another party to the contract. An example is provided in the final regulations illustrating the application of the rule.

2. Simplifying Conventions

The final regulations retain the simplifying conventions applicable to employee compensation, overhead, and *de minimis* costs, with several modifications.

For example, the final regulations treat as employee compensation certain amounts paid to persons who may not be employees of the taxpayer under section 3401(c). Specifically, the final regulations provide that a guaranteed payment to a partner in a partnership is treated as employee compensation. In addition, annual compensation paid to a director of a corporation is treated as employee compensation. The final regulations also provide that, 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 are performed at a time during which both members are affiliated. Other than this rule for entities joining in a consolidated return, the final regulations do not treat employees of one entity as employees of a related entity. The limited exception is made for entities joining in a consolidated return because these entities are appropriately viewed as a single taxpayer for purposes of the employee compensation simplifying convention. The IRS and Treasury Department believe that when other related entities provide services to each other, they generally will maintain records of the time charged and will not be subject to undue recordkeeping burdens as a result of section 263(a).

Several commentators suggested that the simplifying convention for employee compensation should apply to amounts paid to independent contractors who are not hired specifically to facilitate a capital transaction. For example, many companies hire outside contractors to provide administrative and secretarial services, and these contractors work on a variety of transactions, only some of which may be capital. The final regulations extend the employee compensation simplifying convention to amounts paid to outside contractors for secretarial, clerical, and similar administrative services.

The final regulations retain the \$5,000 *de minimis* threshold contained in the proposed regulations. Some commentators suggested that the threshold be a higher amount, or at least be indexed for inflation. The final regulations do not adopt these suggestions, but provide that the IRS may prescribe a higher threshold amount in future published guidance. The final regulations also provide that, for purposes of determining whether a transaction cost paid in the form of property is *de minimis*, the property is valued at its fair market value at the time of the payment. The final regulations also retain the pooling method for *de minimis* transaction costs. See Part II.G. of this Preamble titled "Safe harbor pooling methods" for a further explanation of the rules relating to pooling.

The final regulations permit taxpayers to elect to capitalize employee compensation, overhead, or *de minimis* costs. Several commentators noted that taxpayers may capitalize such costs for financial accounting purposes, and it may be dif-

icult to segregate these costs for federal income tax purposes. The final regulations permit taxpayers to make this capitalization election with regard to any or all of the three categories of costs covered by the simplifying conventions (*i.e.*, employee compensation, overhead, or *de minimis* costs).

F. 12-month rule

The regulations retain the 12-month rule contained in the proposed regulations. Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create (or facilitate the creation of) certain rights or benefits with a brief duration. Some commentators suggested that the first prong of the measuring period should be deleted, resulting in a rule that considers only whether the benefit extends beyond the end of the taxable year following the year in which the payment is made. The final regulations do not adopt this suggestion. The IRS and Treasury continue to believe that the rule contained in the proposed regulations is sufficient to ease the recordkeeping burden for transactions of relatively brief duration.

The final regulations clarify that if a taxpayer is permitted to terminate an agreement described in this rule after a notice period, in determining whether the "12 month rule" applies, amounts paid to terminate the 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.

The final regulations permit taxpayers to elect not to apply the 12-month rule to categories of similar transactions. The IRS and Treasury Department recognize that some taxpayers may capitalize amounts for financial accounting purposes that would not be required to be capitalized for federal income tax purposes due to the 12-month rule. In some cases, it may be difficult for taxpayers to identify and calculate these amounts for purposes of applying the 12-month rule. For this reason, the final regulations permit taxpayers to elect to capitalize these amounts notwithstanding that the 12-month rule would not require capitalization.

G. Safe harbor pooling methods

The final regulations adopt, with slight modifications, the pooling methods con-

tained in the proposed regulations for *de minimis* costs and the 12-month rule. The pooling rules in the final regulations are very general. However, the IRS may publish guidance in the Internal Revenue Bulletin prescribing additional rules for applying the pooling methods to particular industries or to specific types of transactions.

The final regulations provide that a taxpayer may utilize the pooling methods only if the taxpayer reasonably expects to engage in at least 25 similar transactions during the taxable year. The final regulations require a minimum number of similar transactions to prevent inappropriate skewing of the average cost or average benefit period. Although pooling reduces the burden on taxpayers of having to separately analyze each transaction, this burden is not as significant when there are only a small number of transactions to consider.

The final regulations do not require the same pools to be used under the pooling method as are required for depreciation purposes under section 167. However, taxpayers should draw no inferences that a pool permitted under the regulations constitutes an acceptable pool for depreciation purposes under section 167.

A commentator suggested that the final regulations permit taxpayers to estimate the costs (or renewal expectancy) of items included in a pool based on a sample of items included in the pool. The final regulations do not adopt this suggestion. The IRS and Treasury Department believe that it is inappropriate to apply the pooling rules by looking at a sample of items included in the pool. In estimating the renewal expectancy of items in a pool, however, taxpayers are permitted to consider their historic experience with similar items.

The final regulations clarify that a pooling method authorized by the regulations constitutes a method of accounting. Accordingly, a taxpayer that adopts (or changes to) a pooling method authorized by the regulations must use the method for the year of adoption (or year of change) and for all subsequent taxable years during which the taxpayer qualifies to use the method, unless a change to another method is required by the Commissioner, or unless permission to change to another method is granted by the Commissioner.

The final regulations also add a rule that is intended to prevent abuse of the *de minimis* rules through pooling of similar agreements. The IRS and Treasury Department are concerned that one or more large-dollar transactions may qualify under the *de minimis* rule if averaged with numerous small-dollar transactions. To discourage this potential abuse, the regulations prohibit the inclusion of an agreement in the pool if the amount paid to obtain the agreement is reasonably expected to differ significantly from the average amount attributable to other agreements properly included in the pool. The final regulations add an example illustrating the application of this rule.

H. Computer software issues

Based on public comments, the IRS and Treasury Department decided that issues relating to the development and implementation of computer software are more appropriately addressed in separate guidance, and not in these final regulations. While these final regulations require a taxpayer to capitalize an amount paid to another party to acquire computer software from that party in a purchase or similar transaction (see §1.263(a)-4(c)), nothing in these regulations is intended to affect the determination of whether computer software is acquired from another party in a purchase or similar transaction, or whether computer software is developed or otherwise self-created (including amounts paid to implement Enterprise Resource Planning (ERP) software). While the proposed regulations identify ERP implementation costs as an issue to be addressed in the final regulations, the IRS and Treasury Department believe that rules regarding the treatment of such costs are more appropriately addressed in separate guidance dedicated exclusively to computer software issues. Until separate guidance is issued, taxpayers may continue to rely on Revenue Procedure 2000-50, 2000-2 C.B. 601.

III. Explanation and Summary of Comments Concerning §1.263(a)-5

A. In general

Section 1.263(a)-5 contains rules requiring taxpayers to capitalize amounts paid to facilitate the acquisition of a trade

or business, a change in the capital structure of a business entity, and certain other transactions. The types of transactions covered by §1.263(a)-5 are more clearly identified than in paragraph (b)(1)(iii) of the proposed regulations. Section 1.263(a)-5 applies to acquisitions of an ownership interest in an entity conducting a trade or business only if, immediately after the acquisition, the taxpayer and the entity are related within the meaning of section 267(b) or 707(b). Other acquisitions of an ownership interest in an entity are governed by the rules contained in §1.263(a)-4, and not the rules contained in §1.263(a)-5.

Similar to the §1.263(a)-4 final regulations, the §1.263(a)-5 regulations clarify that an amount facilitates a transaction if it is paid in the process of “investigating or otherwise pursuing the transaction” and that an amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing that transaction. In addition, the fact that an amount would (or would not) have been paid “but for” the transaction is a relevant, but not determinative, factor in evaluating whether an amount is paid to facilitate a transaction.

B. Acquisition of assets constituting a trade or business

As explained in the preamble to the proposed regulations, the proposed regulations (and the simplifying conventions in the proposed regulations) apply only to amounts paid to acquire (or facilitate the acquisition of) intangibles acquired as part of a trade or business and do not apply to amounts paid to acquire (or facilitate the acquisition of) tangible assets acquired as part of a trade or business. The preamble to the proposed regulations further notes that the IRS and Treasury Department were considering the application of the rules in the proposed regulations to tangible assets acquired as part of a trade or business in order to provide a single administrable standard in these transactions. To avoid the application of one set of rules to intangible assets acquired in the acquisition of a trade or business and a different set of rules to the tangible assets acquired in the acquisition, the final regulations under §1.263(a)-5 provide a single set of rules for amounts paid to facilitate an

acquisition of a trade or business, regardless of whether the transaction is structured as an acquisition of the entity or as an acquisition of assets (including tangible assets) constituting a trade or business.

C. *Special rules for certain costs*

1. Borrowing Costs

The final regulations retain the rule in the proposed regulations that an amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing).

2. Costs of Asset Sales

The final regulations provide that an amount paid to facilitate a sale of assets does not facilitate a transaction other than the sale, regardless of the circumstances surrounding the sale. This modifies the rule in the proposed regulations, which requires capitalization of amounts paid to facilitate a sale of assets where the sale is required by law, regulatory mandate, or court order and the sale itself facilitates another capital transaction. Several commentators argued that costs to dispose of assets are properly viewed as costs to facilitate the sale, and not costs to facilitate a subsequent transaction. The IRS and Treasury Department have adopted this suggestion and revised the rule in the final regulations.

3. Mandatory Stock Distributions

The final regulations modify the rules in the proposed regulations relating to government mandated divestitures of stock. The proposed regulations provide that capitalization is not required for a distribution of stock by a taxpayer to its shareholders if the divestiture is required by law, regulatory mandate, or court order, except in cases where the divestiture itself facilitates another capital transaction. The final regulations eliminate the exception. In addition, the final regulations clarify that costs to organize an entity to receive the divested properties or to facilitate the transfer of certain divested properties to a distributed entity also are not required to be capitalized under section 263(a). See sections 248 and 709. An example has been added to the final regulations illustrating this rule.

4. Bankruptcy Reorganization Costs

Commentators suggested that the final regulations clarify that not all costs incurred in the process of pursuing a bankruptcy reorganization under Chapter 11 of the Bankruptcy Code must be capitalized. The final regulations contain a special rule defining the scope of bankruptcy costs required to be capitalized. Under the rule, costs of the debtor to institute or administer a Chapter 11 proceeding generally are required to be capitalized. However, costs to operate the debtor's business during a Chapter 11 proceeding (including the types of costs described in Revenue Ruling 77-204, 1977-1 C.B. 40) do not facilitate the bankruptcy and are treated in the same manner as such costs would have been treated had the bankruptcy proceeding not been instituted. In addition, the final regulations provide that capitalization is not required for amounts paid by a taxpayer to defend against the commencement of an involuntary bankruptcy proceeding against the taxpayer.

Commentators specifically requested that the final regulations address the treatment of costs incurred in a Chapter 11 bankruptcy proceeding that is instituted in order to manage and resolve tort claims and distinguish these proceedings from other bankruptcy cases. The final regulations do not distinguish between a bankruptcy proceeding that is instituted to resolve tort claims and other bankruptcy proceedings. However, the final regulations clarify that a specific amount paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization under Chapter 11 that resolves the taxpayer's tort liability is not required to be capitalized if the amount would have been treated as an ordinary and necessary business expense under section 162 had the bankruptcy proceeding not been instituted.

5. Stock Issuance Costs of Open-End Regulated Investment Companies

The final regulations retain the rule that amounts paid by an open-end regulated investment company to facilitate an issuance of its stock are treated as amounts that do not facilitate a capital transaction unless the amounts are paid during the initial stock offering period.

6. Integration Costs

The final regulations retain the rule in the proposed regulations that an amount paid to integrate the business operations of the taxpayer with the business operations of another entity does not facilitate a transaction described in §1.263(a)-5, regardless of when the integration activities occur.

7. Costs Associated with Terminated Transactions

The final regulations clarify when costs of terminating a transaction described in §1.263(a)-5 (including break-up fees) are treated as facilitating another transaction described in §1.263(a)-5. Under the proposed regulations, termination costs facilitate a subsequent transaction if the subsequent transaction is "expressly conditioned" on the termination. The final regulations do not contain an "expressly conditioned" rule. Instead, an amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction described in the regulations is treated as facilitating another transaction described in the regulations only if the transactions are mutually exclusive and the agreement is terminated to enable the taxpayer to engage in the second transaction. In addition, an amount paid to facilitate a transaction described in the regulations is treated as facilitating a second transaction described in the regulations only if the transactions are mutually exclusive and the first transaction is abandoned to enable the taxpayer to engage in the second transaction. The final regulations contain several examples to demonstrate the application of these rules.

D. *Simplifying conventions*

In general, the simplifying conventions applicable to transactions described in §1.263(a)-5 are similar to the simplifying conventions applicable to acquisitions or creations of intangibles governed by §1.263(a)-4. See Part II.E.2 of this Preamble titled "Simplifying Conventions" for an explanation of the simplifying conventions applicable to the acquisition or creation of an intangible governed by §1.263(a)-4.

The simplifying convention for employee compensation treats amounts paid to persons who are not employees as

employee compensation if the amounts are paid for secretarial, clerical, or similar administrative support services. In the context of transactions described in §1.263(a)-5, this rule does not apply to services involving the preparation and distribution of proxy solicitations and other documents seeking shareholder approval of a transaction described in §1.263(a)-5. The IRS and Treasury Department believe that these inherently facilitative services, which are commonly performed by independent contractors, are appropriately capitalized.

In addition, the final regulations provide that the term “*de minimis* costs” does not include commissions paid to facilitate a transaction described in §1.263(a)-5. This rule maintains consistency with the rule in §1.263(a)-4(e)(4)(iii)(B), which provides that the *de minimis* rule does not apply to commissions paid to facilitate the acquisition or creation of certain financial interests.

E. *Special rules for certain acquisitive transactions*

The final regulations contain a “bright line date” rule and an “inherently facilitative” rule intended to aid the determination of amounts paid to facilitate certain acquisitive transactions. The final regulations modify the bright line date rule provided in the proposed regulations. Under the final regulations, an amount (that is not an inherently facilitative amount) facilitates the transaction only if the amount relates to activities performed on or after the earlier of (i) the date on which a letter of intent, exclusivity agreement, or similar written communication is executed by representatives of the acquirer and the target or (ii) the date on which the material terms of the transaction are authorized or approved by the taxpayer’s board of directors (or other appropriate governing officials). Where board approval is not required for a particular transaction, the bright line date for the second prong of the test is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.

Many comments were received concerning the bright line dates. Some commentators noted that any bright line date is inappropriate and that the determination should be based on all of the facts and

circumstances surrounding the transaction. As discussed in the preamble to the proposed regulations, the IRS and Treasury Department continue to believe that a bright line rule is necessary to eliminate the subjectivity and controversy inherent in this area. Further, the IRS and Treasury Department believe that the bright line rule is within the scope of the authority of the IRS and Treasury Department to prescribe rules necessary to enforce the requirements of section 263(a), and that the bright line rule, as modified in these final regulations, serves as an appropriate and objective standard for determining the point in time at which amounts paid in certain acquisitive transactions must be capitalized.

Some commentators who agreed with the use of a bright line date rule to improve administrability of section 263(a) suggested that the bright line date should be the date the taxpayer’s board of directors approves a transaction. The date of the board of directors approval may, in some cases, be the date determined under the rule contained in the final regulations. However, the IRS and Treasury Department believe that an earlier date is more appropriate where the parties have mutually agreed to pursue a transaction, notwithstanding the fact that the parties are not bound to complete the transaction. Accordingly, the rule requires capitalization if the parties execute a letter of intent, exclusivity agreement, or similar written communication. The term *similar written communication* in the rule is not intended to include a confidentiality agreement.

The board of directors approval date contemplated by the rule is not the date the board authorizes a committee (or management) to explore the possibility of a transaction with another party. Additionally, the board of directors approval date contemplated by the rule is not intended to be the date the board ratifies a shareholder vote in favor of the transaction.

Some commentators suggested that the final regulations clarify how the bright line date rule applies to a target that puts itself up for auction. These commentators noted that, under the proposed regulations, submission of a bid by a bidder could trigger the bright line date for the target, even if the target has not made any decision regarding the bid. Under the final regulations, submission of a bid by a bidder does

not trigger the bright line date for the target because the first part of the test requires execution by both the acquirer and the target and the second part of the test is applied independently by the acquirer and the target. The final regulations include an example illustrating the application of the rule in this case.

The final regulations specifically identify the types of transactions to which the bright line date and inherently facilitative rules apply. Some commentators suggested that the final regulations extend the rule to apply not only to acquisitive transactions, but to spin-offs, stock offerings, and acquisitions of individual assets that do not constitute a trade or business. The IRS and Treasury Department believe that the bright line test is not suitable for these transactions and that amounts paid in the process of investigating or otherwise pursuing these transactions are appropriately capitalized.

Regarding the inherently facilitative rule contained in the proposed regulations, several commentators suggested that the rule be deleted or changed to a rebuttable presumption that the identified amounts are capital. The final regulations do not adopt this suggestion. The IRS and Treasury Department believe that the list of inherently facilitative amounts properly identifies certain types of costs that are capital regardless of when they are incurred. In addition, a rebuttable presumption would not provide the certainty sought by the regulations. However, the final regulations modify the list of inherently facilitative amounts to more clearly identify the types of costs considered inherently facilitative. For example, the proposed regulations treat “amounts paid for activities performed in determining the value of the target” as inherently facilitative costs. Commentators expressed concerns that this language would require taxpayers to capitalize all due diligence costs. The final regulations tighten this category to include amounts paid for “securing an appraisal, formal written evaluation, or fairness opinion related to the transaction.” General due diligence costs are intended to be addressed by the bright line test, not the inherently facilitative rules.

Some commentators questioned whether the regulations are intended to affect the treatment of an expenditure un-

der section 195. As a result of section 195(c)(1)(B), the regulations are relevant in determining whether an expenditure constitutes a start-up expenditure within the meaning of section 195. An amount cannot constitute a start-up expenditure within the meaning of section 195(c)(1)(B) if the amount is a capital expenditure under section 263(a). Accordingly, amounts required to be capitalized under the final regulations do not constitute start-up expenditures within the meaning of section 195(c)(1). Conversely, amounts that are not required to be capitalized under the final regulations may constitute start-up expenditures within the meaning of section 195(c)(1) provided the other requirements of that section are met.

F. Hostile takeover defense costs

The IRS and Treasury Department decided that the rules in the proposed regulations for amounts paid to defend against a hostile takeover attempt are unnecessary. The hostile transaction rule in the proposed regulations does not permit taxpayers to deduct costs that otherwise would have been capitalized under the regulations. For example, the hostile transaction rule does not apply to any inherently facilitative costs or to costs that facilitate another capital transaction (for example, a recapitalization or a proposed merger with a white knight). Other amounts that a target would pay in defending against a hostile acquisition would not be capitalized under the final regulations either because the costs would not be paid in investigating or otherwise pursuing the transaction with the hostile acquirer (for example, costs to seek an injunction against the acquisition) or would relate to activities performed before the bright line dates (while the transaction is hostile, the target will not execute any agreements with the acquirer and the target's board of directors will not authorize the acquisition). Thus, the IRS and Treasury Department believe the hostile transaction rule in the proposed regulations is unnecessary and could cause needless controversy over when a transaction changes from hostile to friendly. Accordingly, the final regulations do not contain any special rules related to hostile acquisition attempts. The final regulations contain an example illustrating how the regulations

apply in the context of a hostile acquisition attempt.

G. Documentation of success-based fees

Under the proposed regulations, a payment that is contingent on the successful closing of an acquisition facilitates the acquisition except to the extent that evidence clearly demonstrates that some portion of the payment is allocable to activities that do not facilitate the acquisition. The final regulations retain the success-based fee rule, but extend it to all transactions to which §1.263(a)-5 applies, instead of just acquisitive transactions. In addition, the final regulations eliminate the "clearly demonstrates" standard in favor of a rule providing that success-based fees facilitate a transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. The regulations require that this documentation consist of more than a mere allocation between activities that facilitate the transaction and activities that do not facilitate the transaction.

H. Treatment of capitalized costs

The final regulations provide that amounts required to be capitalized by an acquirer in a taxable acquisitive transaction are added to the basis of the acquired assets in an asset transaction or to the basis of the acquired stock in a stock transaction. Amounts required to be capitalized by the target in an acquisition of its assets in a taxable transaction are treated as a reduction of the target's amount realized on the disposition of its assets.

The final regulations do not address the treatment of amounts required to be capitalized in certain other transactions to which §1.263(a)-5 applies (for example, amounts required to be capitalized in tax-free transactions, costs of a target in a taxable stock acquisition and stock issuance costs). The IRS and Treasury Department intend to issue separate guidance to address the treatment of these amounts and will consider at that time whether such amounts should be eligible for the 15-year safe harbor amortization period described in §1.167(a)-3.

IV. Effective Dates and Changes in Methods of Accounting

The final regulations under §§1.263(a)-4 and 1.263(a)-5 apply to amounts paid or incurred on or after December 31, 2003. Except as provided below regarding changes to a pooling method authorized by these regulations, a taxpayer seeking to change a method of accounting to comply with the final regulations must make the change on a modified cut-off basis, taking into account for purposes of section 481(a) only amounts paid or incurred in taxable years ending on or after January 24, 2002 (the date of publication of the advance notice of proposed rulemaking in the **Federal Register**).

As explained in the preamble to the proposed regulations, the IRS and Treasury Department are concerned that an unrestricted section 481(a) adjustment for changes in methods of accounting made to comply with these regulations would create administrative burdens on taxpayers and the IRS. In addition, many of the simplification conventions in the final regulations (including the 12-month rule and the rules for employee compensation, overhead and *de minimis* costs) represent a change in the position traditionally taken by the IRS and the Treasury Department in interpreting section 263(a). However, the IRS and Treasury Department also want to reduce the potential for inconsistent treatment of conservative and aggressive taxpayers. Allowing a section 481(a) adjustment for amounts paid or incurred in taxable years ending on or after the date of the advance notice of proposed rulemaking achieves the best balance of these concerns.

For changes relating to the use of a pooling method under §1.263(a)-4, taxpayers must apply a cut-off method. Applying a cut-off method reduces the burden on taxpayers of having to determine which assets fit into a pool on a retroactive basis.

The preamble to the proposed regulations provides that taxpayers may not change a method of accounting in reliance upon the rules contained in the proposed regulations until the rules are published as final regulations. Nonetheless, the IRS has received numerous Forms 3115 from taxpayers seeking the Commissioner's consent to change their method of accounting

for items addressed in the advance notice of proposed rulemaking or in the proposed regulations. The IRS suspended processing of these requests pending publication of these final regulations. Upon publication of the final regulations, the IRS intends to process these requests in a manner consistent with the rules contained in the final regulations, including the effective date rules and rules relating to the computation of the section 481(a) adjustment. For example, if the change is requested for a taxable year ending prior to the effective date of the final regulations and concerns a method of accounting that the Commissioner does not recognize as permissible prior to the effective date of the final regulations, the IRS intends to reject the request. Similarly, if the change is requested for a taxable year ending on or after the effective date of the final regulations and concerns a method of accounting that is permissible under the final regulations, the IRS intends to return the request to the taxpayer (and refund the user fee) and advise the taxpayer to utilize the automatic consent procedures as authorized by the final regulations. Subsequent to the publication of these final regulations, the IRS may issue additional guidance for utilizing the automatic consent procedures as authorized by these regulations. Unless these regulations specifically identify a treatment of amounts as a method of accounting (for example, the safe harbor pooling methods), nothing in these regulations is intended to address whether the treatment of amounts to which these regulations apply constitutes a method of accounting.

V. Explanation of Amendments to §1.167(a)-3

The final regulations essentially retain the amendments to §1.167(a)-3 as contained in the proposed regulations. The final regulations provide that those amendments are effective for intangible assets created on or after the date the final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment

is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information requirement in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the regulations merely require a taxpayer to retain records substantiating amounts paid in the process of investigating or otherwise pursuing certain transactions involving the acquisition of a trade or business. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. The Chief Counsel for Advocacy did not submit any comments on the regulations.

Drafting Information

The principal author of these final regulations is Andrew J. Keyso of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART I — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:
Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.167(a)-3 is amended by:

1. Designating the text of the section as paragraph (a) and adding a heading to newly designated paragraph (a).

2. Adding paragraph (b).

The additions read as follows:

§1.167(a)-3 *Intangibles*.

(a) *In general*. * * *

(b) *Safe harbor amortization for certain intangible assets* — (1) *Useful life*. Solely

for purposes of determining the depreciation allowance referred to in paragraph (a) of this section, a taxpayer may treat an intangible asset as having a useful life equal to 15 years unless —

(i) An amortization period or useful life for the intangible asset is specifically prescribed or prohibited by the Internal Revenue Code, the regulations thereunder (other than by this paragraph (b)), or other published guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter);

(ii) The intangible asset is described in §1.263(a)-4(c) (relating to intangibles acquired from another person) or §1.263(a)-4(d)(2) (relating to created financial interests);

(iii) The intangible asset has a useful life the length of which can be estimated with reasonable accuracy; or

(iv) The intangible asset is described in §1.263(a)-4(d)(8) (relating to certain benefits arising from the provision, production, or improvement of real property), in which case the taxpayer may treat the intangible asset as having a useful life equal to 25 years solely for purposes of determining the depreciation allowance referred to in paragraph (a) of this section.

(2) *Applicability to acquisitions of a trade or business, changes in the capital structure of a business entity, and certain other transactions*. The safe harbor useful life provided by paragraph (b)(1) of this section does not apply to an amount required to be capitalized by §1.263(a)-5 (relating to amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions).

(3) *Depreciation method*. A taxpayer that determines its depreciation allowance for an intangible asset using the 15-year useful life prescribed by paragraph (b)(1) of this section (or the 25-year useful life in the case of an intangible asset described in §1.263(a)-4(d)(8)) must determine the allowance by amortizing the basis of the intangible asset (as determined under section 167(c) and without regard to salvage value) ratably over the useful life beginning on the first day of the month in which the intangible asset is placed in service by the taxpayer. The intangible asset is not eligible for amortization in the month of disposition.

(4) *Effective date.* This paragraph (b) applies to intangible assets created on or after December 31, 2003.

Par. 3. Section 1.263(a)-0 is added to read as follows:

§1.263(a)-0 Table of contents.

This section lists captioned paragraphs contained in §§1.263(a)-1 through 1.263(a)-5.

§1.263(a)-1 Capital expenditures; in general.

§1.263(a)-2 Examples of capital expenditures.

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

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

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 - (4) Coordination with other provisions of the Internal Revenue Code.
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- (c) Special rules for certain costs.
 - (1) Borrowing costs.
 - (2) Costs of asset sales.
 - (3) Mandatory stock distributions.
 - (4) Bankruptcy reorganization costs.
 - (5) Stock issuance costs of open-end regulated investment companies.
 - (6) Integration costs.

(7) Registrar and transfer agent fees for the maintenance of capital stock records.

(8) Termination payments and amounts paid to facilitate mutually exclusive transactions.

(d) Simplifying conventions.

(1) In general.

(2) Employee compensation.

(i) In general.

(ii) Certain amounts treated as employee compensation.

(3) *De minimis* costs.

(i) In general.

(ii) Treatment of commissions.

(4) Election to capitalize.

(e) Certain acquisitive transactions.

(1) In general.

(2) Exception for inherently facilitative amounts.

(3) Covered transactions.

(f) Documentation of success-based fees.

(g) Treatment of capitalized costs.

(1) Tax-free acquisitive transactions [Reserved].

(2) Taxable acquisitive transactions.

(i) Acquirer.

(ii) Target.

(3) Stock issuance transactions [Reserved].

(4) Borrowings.

(5) Treatment of capitalized amounts by option writer.

(h) Application to accrual method taxpayers.

(i) [Reserved].

(j) Coordination with other provisions of the Internal Revenue Code.

(k) Treatment of indirect payments.

(l) Examples.

(m) Effective date.

(n) Accounting method changes.

(1) In general.

(2) Scope limitations.

(3) Section 481(a) adjustment.

Par. 4. Sections 1.263(a)-4 and 1.263(a)-5 are added to read as follows:

§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 pro-

vides 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, fed-

eral 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 de-

sign 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 trade-name (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 inter-

ests, 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));

(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

(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.

(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. Accordingly, 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 imme-

diately 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 in-

tangible 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 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 investigating 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 \$8,000 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 ex-

pectancy 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 paragraph (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 sec-

tion (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 sys-

tem. 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 acquisi-

tion 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.

(ii) 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.

§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 cap-

itized by §1.263(a)-1, §1.263(a)-2, or §1.263(a)-4 does not facilitate a transaction described in paragraph (a) of this section.

(c) *Special rules for certain costs* — (1) *Borrowing costs.* An amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing) described in paragraph (a) of this section.

(2) *Costs of asset sales.* An amount paid by a taxpayer to facilitate a sale of its assets does not facilitate another transaction (other than the sale) described in paragraph (a) of this section. For example, where a target corporation, in preparation for a merger with an acquiring corporation, sells assets that are not desired by the acquiring corporation, amounts paid to facilitate the sale of the unwanted assets are not required to be capitalized as amounts paid to facilitate the merger.

(3) *Mandatory stock distributions.* An amount paid in the process of investigating or otherwise pursuing a distribution of stock by a taxpayer to its shareholders does not facilitate a transaction described in paragraph (a) of this section if the divestiture of the stock (or of properties transferred to an entity whose stock is distributed) is required by law, regulatory mandate, or court order. A taxpayer is not required to capitalize (under this section or §1.263(a)-4) an amount paid to organize (or facilitate the organization of) an entity if the entity is organized solely to receive properties that the taxpayer is required to divest by law, regulatory mandate, or court order and if the taxpayer distributes the stock of the entity to its shareholders. A taxpayer also is not required to capitalize (under this section or §1.263(a)-4) an amount paid to transfer property to an entity if the taxpayer is required to divest itself of that property by law, regulatory mandate, or court order and if the stock of the recipient entity is distributed to the taxpayer's shareholders.

(4) *Bankruptcy reorganization costs.* An amount paid to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code by a taxpayer that is the debtor under the proceeding constitutes an amount paid to facilitate a reorganization within the meaning of paragraph (a)(4) of this section, regardless of the purpose for which the proceeding is instituted. For example, an amount paid to prepare and file a petition under Chapter 11, to ob-

tain an extension of the exclusivity period under Chapter 11, to formulate plans of reorganization under Chapter 11, to analyze plans of reorganization formulated by another party in interest, or to contest or obtain approval of a plan of reorganization under Chapter 11 facilitates a reorganization within the meaning of this section. However, amounts specifically paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization under Chapter 11 that resolves tort liabilities of the taxpayer do not facilitate a reorganization within the meaning of paragraph (a)(4) of this section if the amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. In addition, an amount paid by the taxpayer to defend against the commencement of an involuntary bankruptcy proceeding against the taxpayer does not facilitate a reorganization within the meaning of paragraph (a)(4) of this section. An amount paid by the debtor to operate its business during a Chapter 11 bankruptcy proceeding is not an amount paid to institute or administer the bankruptcy proceeding and does not facilitate a reorganization. Such amount is treated in the same manner as it would have been treated had the bankruptcy proceeding not been instituted.

(5) *Stock issuance costs of open-end regulated investment companies.* Amounts paid by an open-end regulated investment company (within the meaning of section 851) to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section unless the amounts are paid during the initial stock offering period.

(6) *Integration costs.* An amount paid to integrate the business operations of the taxpayer with the business operations of another does not facilitate a transaction described in paragraph (a) of this section, regardless of when the integration activities occur.

(7) *Registrar and transfer agent fees for the maintenance of capital stock records.* An amount paid by a taxpayer to a registrar or transfer agent in connection with the transfer of the taxpayer's capital stock does not facilitate a transaction described in paragraph (a) of this section unless the amount is paid with respect to a specific

transaction described in paragraph (a). For example, a taxpayer is not required to capitalize periodic payments to a transfer agent for maintaining records of the names and addresses of shareholders who trade the taxpayer's shares on a national exchange. By comparison, a taxpayer is required to capitalize an amount paid to the transfer agent for distributing proxy statements requesting shareholder approval of a transaction described in paragraph (a) of this section.

(8) *Termination payments and amounts paid to facilitate mutually exclusive transactions.* An amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction described in paragraph (a) of this section constitutes an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive. An amount paid to facilitate a transaction described in paragraph (a) of this section is treated as an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive.

(d) *Simplifying conventions* — (1) *In general.* For purposes of this section, employee compensation (within the meaning of paragraph (d)(2) of this section), overhead, and *de minimis* costs (within the meaning of paragraph (d)(3) of this section) are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section.

(2) *Employee compensation* — (i) *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.

(ii) *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 the 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 (other than services involving the preparation and distribution of proxy solicitations and other documents seeking shareholder approval of a transaction described in paragraph (a) of this section). 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.

(3) *De minimis costs* — (i) *In general.* The term *de minimis costs* means amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a) of this section 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 (d)(3). For purposes of this paragraph (d)(3), an amount paid in the form of property is valued at its fair market value at the time of the payment.

(ii) *Treatment of commissions.* The term *de minimis costs* does not include commissions paid to facilitate a transaction described in paragraph (a) of this section.

(4) *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 described in paragraph (a) of this section 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 (d)(4) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(e) *Certain acquisitive transactions* — (1) *In general.* Except as provided in paragraph (e)(2) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction (as described in paragraph (e)(3) of this section) facilitates the transaction within the meaning of this section only if the amount relates to activities performed on or after the earlier of —

(i) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or

(ii) The date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) the date determined under this paragraph (e)(1)(ii) is the date on which the acquirer and the target execute a binding written

contract reflecting the terms of the transaction.

(2) *Exception for inherently facilitative amounts.* An amount paid in the process of investigating or otherwise pursuing a covered transaction facilitates that transaction if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined under paragraph (e)(1) of this section. An amount is inherently facilitative if the amount is paid for —

(i) Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;

(ii) Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (for example, obtaining tax advice on the application of section 368);

(iii) Preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement);

(iv) Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;

(v) Obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or

(vi) Conveying property between the parties to the transaction (for example, transfer taxes and title registration costs).

(3) *Covered transactions.* For purposes of this paragraph (e), the term *covered transaction* means the following transactions:

(i) A taxable acquisition by the taxpayer of assets that constitute a trade or business.

(ii) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b).

(iii) A reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

(f) *Documentation of success-based fees* — An amount paid that is contingent on the successful closing of a transaction described in paragraph (a) of this section is an amount paid to facilitate the transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. This documentation must be completed on or before the due date of the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the transaction closes. For purposes of this paragraph (f), documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and must consist of supporting records (for example, time records, itemized invoices, or other records) that identify —

(1) The various activities performed by the service provider;

(2) The amount of the fee (or percentage of time) that is allocable to each of the various activities performed;

(3) Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and

(4) The name, business address, and business telephone number of the service provider.

(g) *Treatment of capitalized costs* — (1) *Tax-free acquisitive transactions*. [Reserved].

(2) *Taxable acquisitive transactions* — (i) *Acquirer*. In the case of an acquisition, merger, or consolidation that is not described in section 368, an amount required to be capitalized under this section by the acquirer is added to the basis of the acquired assets (in the case of a transaction that is treated as an acquisition of the assets of the target for federal income tax purposes) or the acquired stock (in the case of a transaction that is treated as an acquisition of the stock of the target for federal income tax purposes).

(ii) *Target* — (A) *Asset acquisition*. In the case of an acquisition, merger, or consolidation that is not described in section 368 and that is treated as an acquisition of the assets of the target for federal in-

come tax purposes, an amount required to be capitalized under this section by the target is treated as a reduction of the target's amount realized on the disposition of its assets.

(B) *Stock acquisition*. [Reserved].

(3) *Stock issuance transactions*. [Reserved].

(4) *Borrowings*. For the treatment of amounts required to be capitalized under this section with respect to a borrowing, see §1.446-5.

(5) *Treatment of capitalized amounts by option writer*. An amount required to be capitalized by an option writer under paragraph (a)(10) of this section is not currently deductible under section 162 or 212. Instead, the amount required to be capitalized generally reduces the total premium received by the option writer. However, other provisions of law may limit the reduction of the premium by the capitalized amount (for example, if the capitalized amount is never deductible by the option writer).

(h) *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.

(i) [Reserved].

(j) *Coordination with other provisions of the Internal Revenue Code*. 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 regulations thereunder.

(k) *Treatment of indirect payments*. For purposes of this section, references to an amount paid to or by a party include an amount paid on behalf of that party.

(l) *Examples*. The following examples illustrate the rules of this section:

Example 1. Costs to facilitate. Q corporation pays its outside counsel \$20,000 to assist Q in registering its stock with the Securities and Exchange Commission. Q is not a regulated investment company within the meaning of section 851. Q's payments to its outside counsel are amounts paid to facilitate the issuance of stock. Accordingly, Q must capitalize its \$20,000 payment under paragraph (a)(8) of this section (whether incurred before or after the is-

suance of the stock and whether or not the registration is productive of equity capital).

Example 2. Costs to facilitate. Q corporation seeks to acquire all of the outstanding stock of Y corporation. To finance the acquisition, Q must issue new debt. Q pays an investment banker \$25,000 to market the debt to the public and pays its outside counsel \$10,000 to prepare the offering documents for the debt. Q's payment of \$35,000 facilitates a borrowing and must be capitalized under paragraph (a)(9) of this section. As provided in paragraph (c)(1) of this section, Q's payment does not facilitate the acquisition of Y, notwithstanding the fact that Q incurred the new debt to finance its acquisition of Y. See §1.446-5 for the treatment of Q's capitalized payment.

Example 3. Costs to facilitate. (i) Z agrees to pay investment banker B \$1,000,000 for B's services in evaluating four alternative transactions (\$250,000 for each alternative): an initial public offering; a borrowing of funds; an acquisition by Z of a competitor; and an acquisition of Z by a competitor. Z eventually decides to pursue a borrowing and abandons the other options.

(ii) The \$250,000 payment to evaluate the possibility of a borrowing is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(9) of this section. Accordingly Z must capitalize that \$250,000 payment to B. See §1.446-5 for the treatment of Z's capitalized payment.

(iii) The \$250,000 payment to evaluate the possibility of an initial public offering is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(8) of this section. Accordingly, Z must capitalize that \$250,000 payment to B under this section. Because the borrowing and the initial public offering are not mutually exclusive transactions, the \$250,000 is not treated as an amount paid to facilitate the borrowing. When Z abandons the initial public offering, Z may recover under section 165 the \$250,000 paid to facilitate the initial public offering.

(iv) The \$500,000 paid by Z to evaluate the possibilities of an acquisition of Z by a competitor and an acquisition of a competitor by Z are amounts paid in the process of investigating or otherwise pursuing transactions described in paragraphs (a) and (e)(3) of this section. Accordingly, Z is only required to capitalize under this section the portion of the \$500,000 payment that relates to inherently facilitative activities under paragraph (e)(2) of this section or to activities performed on or after the date determined under paragraph (e)(1) of this section. Because the borrowing and the possible acquisitions are not mutually exclusive transactions, no portion of the \$500,000 is treated as an amount paid to facilitate the borrowing. When Z abandons the acquisition transactions, Z may recover under section 165 any portion of the \$500,000 that was paid to facilitate the acquisitions.

Example 4. Corporate acquisition. (i) On February 1, 2005, R corporation decides to investigate the acquisition of three potential targets: T corporation, U corporation, and V corporation. R's consideration of T, U, and V represents the consideration of three distinct transactions, any or all of which R might consummate and has the financial ability to consummate. On March 1, 2005, R enters into an exclusivity agreement with T and stops pursuing U and V. On July 1,

2005, R acquires all of the stock of T in a transaction described in section 368. R pays \$1,000,000 to an investment banker and \$50,000 to its outside counsel to conduct due diligence on T, U, and V; determine the value of T, U, and V; negotiate and structure the transaction with T; draft the merger agreement; secure shareholder approval; prepare SEC filings; and obtain the necessary regulatory approvals.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on T, U and V prior to March 1, 2005 (the date of the exclusivity agreement), are not amounts paid to facilitate the acquisition of the stock of T, U or V and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on T on and after March 1, 2005, are amounts paid to facilitate the acquisition of the stock of T and must be capitalized under paragraph (a)(2) of this section.

(iii) Under paragraph (e)(2) of this section, the amounts paid to determine the value of T, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain necessary regulatory approvals are inherently facilitative amounts paid to facilitate the acquisition of the stock of T and must be capitalized, regardless of whether those activities occur prior to, on, or after March 1, 2005.

(iv) Under paragraph (e)(2) of this section, the amounts paid to determine the value of U and V are inherently facilitative amounts paid to facilitate the acquisition of U or V and must be capitalized. Because the acquisition of U, V, and T are not mutually exclusive transactions, the costs that facilitate the acquisition of U and V do not facilitate the acquisition of T. Accordingly, the amounts paid to determine the value of U and V may be recovered under section 165 in the taxable year that R abandons the planned mergers with U and V.

Example 5. Corporate acquisition; employee bonus. Assume the same facts as in *Example 4*, except R pays a bonus of \$10,000 to one of its corporate officers who negotiated the acquisition of T. As provided by paragraph (d)(1) of this section, Y is not required to capitalize any portion of the bonus paid to the corporate officer.

Example 6. Corporate acquisition; integration costs. Assume the same facts as in *Example 4*, except that, before and after the acquisition is consummated, R incurs costs to relocate personnel and equipment, provide severance benefits to terminated employees, integrate records and information systems, prepare new financial statements for the combined entity, and reduce redundancies in the combined business operations. Under paragraph (c)(6) of this section, these costs do not facilitate the acquisition of T. Accordingly, R is not required to capitalize any of these costs under this section.

Example 7. Corporate acquisition; compensation to target's employees. Assume the same facts as in *Example 4*, except that, prior to the acquisition, certain employees of T held unexercised options issued pursuant to T's stock option plan. These options granted the employees the right to purchase T stock at a fixed option price. The options did not have a readily ascertainable value (within the meaning of § 1.83-7(b)), and thus no amount was included in the employees' income when the options were granted. As a condition of the acquisition, T is required to terminate its stock option plan. T therefore agrees to pay

its employees who hold unexercised stock options the difference between the option price and the current value of T's stock in consideration of their agreement to cancel their unexercised options. Under paragraph (d)(1) of this section, T is not required to capitalize the amounts paid to its employees. See section 83 for the treatment of amounts received in cancellation of stock options.

Example 8. Asset acquisition; employee compensation. N corporation owns tangible and intangible assets that constitute a trade or business. M corporation purchases all the assets of N in a taxable transaction. Under paragraph (a)(1) of this section, M must capitalize amounts paid to facilitate the acquisition of the assets of N. Under paragraph (d)(1) of this section, no portion of the salaries of M's employees who work on the acquisition are treated as facilitating the transaction.

Example 9. Corporate acquisition; retainer. Y corporation's outside counsel charges Y \$60,000 for services rendered in facilitating the friendly acquisition of the stock of Y corporation by X corporation. Y has an agreement with its outside counsel under which Y pays an annual retainer of \$50,000. Y's outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y's outside counsel offsets \$50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of \$10,000. The \$60,000 legal fee is an amount paid to facilitate the acquisition of an ownership interest in Y as described in paragraph (a)(3) of this section. Y must capitalize the full amount of the \$60,000 legal fee.

Example 10. Corporate acquisition; antitrust defense costs. On March 1, 2005, V corporation enters into an agreement with X corporation to acquire all of the outstanding stock of X. On April 1, 2005, federal and state regulators file suit against V to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. V enters into a consent agreement with regulators on May 1, 2005, that allows the acquisition to proceed, but requires V to hold separate the business operations of X pending the outcome of the antitrust suit and subjects V to possible divestiture. V acquires title to all of the outstanding stock of X on June 1, 2005. After June 1, 2005, the regulators pursue antitrust litigation against V seeking rescission of the acquisition. V pays \$50,000 to its outside counsel for services rendered after June 1, 2005, to defend against the antitrust litigation. V ultimately prevails in the antitrust litigation. V's costs to defend the antitrust litigation are costs to facilitate its acquisition of the stock of X under paragraph (a)(2) of this section and must be capitalized. Although title to the shares of X passed to V prior to the date V incurred costs to defend the antitrust litigation, the amounts paid by V are paid in the process of pursuing the acquisition of the stock of X because the acquisition was not complete until the antitrust litigation was ultimately resolved. V must capitalize the \$50,000 in legal fees.

Example 11. Corporate acquisition; defensive measures. (i) On January 15, 2005, Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential "white

knight" acquirer. Y also pays amounts to complete a defensive recapitalization, and pays \$50,000 to an investment banker for a fairness opinion regarding Z's initial offer. Y's efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2005, Y's board of directors decides to abandon its defense against the takeover and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its defense against the takeover, Y pays an investment banker \$1,000,000 for a second fairness opinion and for services rendered in negotiating with Z.

(ii) The legal fees paid by Y to seek an injunction against the takeover are not amounts paid in the process of investigating or otherwise pursuing the transaction with Z. Accordingly, these legal fees are not required to be capitalized under this section.

(iii) The investment banking fees paid to search for a white knight acquirer do not facilitate an acquisition of Y by a white knight because none of Y's costs with respect to a white knight were inherently facilitative amounts and because Y did not reach the date described in paragraph (e)(1) of this section with respect to a white knight. Accordingly, these amounts are not required to be capitalized under this section.

(iv) The amounts paid by Y to investigate and complete the recapitalization must be capitalized under paragraph (a)(4) of this section.

(v) The \$50,000 paid to the investment bankers for a fairness opinion during Y's defense against the takeover and the \$1,000,000 paid to the investment bankers after Y abandons its defense against the takeover are inherently facilitative amounts with respect to the transaction with Z and must be capitalized under paragraph (a)(3) of this section.

Example 12. Corporate acquisition; acquisition by white knight. (i) Assume the same facts as in *Example 11*, except that Y's investment bankers identify three potential white knight acquirers: U corporation, V corporation, and W corporation. Y pays its investment bankers to conduct due diligence on the three potential white knight acquirers. On March 15, 2005, Y's board of directors approves a tentative acquisition agreement under which W agrees to acquire all of the stock of Y, and the investment bankers stop due diligence on U and V. On June 15, 2005, W acquires all of the stock of Y.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on U, V, and W prior to March 15, 2005 (the date of board of directors' approval) are not amounts paid to facilitate the acquisition of the stock of Y and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on W on and after March 15, 2005, facilitate the acquisition of the stock of Y and are required to be capitalized.

Example 13. Corporate acquisition; mutually exclusive costs. (i) Assume the same facts as in *Example 11*, except that Y's investment banker finds W, a white knight. Y and W execute a letter of intent on March 10, 2005. Under the terms of the letter of intent, Y must pay W a \$10,000,000 break-up fee if the merger with W does not occur. On April 1, 2005, Z significantly increases the amount of its offer, and Y decides to accept Z's offer instead of merging with W. Y pays its investment banker \$500,000 for inherently facilitative costs with respect to the potential merger with W. Y also pays its investment banker \$2,000,000 for due diligence costs with respect to the potential

merger with W, \$1,000,000 of which relates to services performed on or after March 10, 2005.

(ii) Y's \$500,000 payment for inherently facilitative costs and Y's \$1,000,000 payment for due diligence activities performed on or after March 10, 2005 (the date the letter of intent with W is entered into), facilitate the potential merger with W. Because Y could not merge with both W and Z, under paragraph (c)(8) of this section the \$500,000 and \$1,000,000 payments also facilitate the transaction between Y and Z. Accordingly, Y must capitalize the \$500,000 and \$1,000,000 payments as amounts that facilitate the transaction with Z.

(iii) Similarly, because Y could not merge with both W and Z, under paragraph (c)(8) of this section the \$10,000,000 termination payment facilitates the transaction between Y and Z. Accordingly, Y must capitalize the \$10,000,000 termination payment as an amount that facilitates the transaction with Z.

Example 14. Break-up fee; transactions not mutually exclusive. N corporation and U corporation enter into an agreement under which U would acquire all the stock or all the assets of N in exchange for U stock. Under the terms of the agreement, if either party terminates the agreement, the terminating party must pay the other party \$10,000,000. U decides to terminate the agreement and pays N \$10,000,000. Shortly thereafter, U acquires all the stock of V corporation, a competitor of N. U had the financial resources to have acquired both N and V. U's \$10,000,000 payment does not facilitate U's acquisition of V. Accordingly, U is not required to capitalize the \$10,000,000 payment under this section.

Example 15. Corporate reorganization; initial public offering. Y corporation is a closely held corporation. Y's board of directors authorizes an initial public offering of Y's stock to fund future growth. Y pays \$5,000,000 in professional fees for investment banking services related to the determination of the offering price and legal services related to the development of the offering prospectus and the registration and issuance of stock. The investment banking and legal services are performed both before and after board authorization. Under paragraph (a)(8) of this section, the \$5,000,000 is an amount paid to facilitate a stock issuance.

Example 16. Auction. (i) N corporation seeks to dispose of all of the stock of its wholly owned subsidiary, P corporation, through an auction process and requests that each bidder submit a non-binding purchase offer in the form of a draft agreement. Q corporation hires an investment banker to assist in the preparation of Q's bid to acquire P and to conduct a due diligence investigation of P. On July 1, 2005, Q submits its draft agreement. On August 1, 2005, N informs Q that it has accepted Q's offer, and presents Q with a signed letter of intent to sell all of the stock of P to Q. On August 5, 2005, Q's board of directors approves the terms of the transaction and authorizes Q to execute the letter of intent. Q executes a binding letter of intent with N on August 6, 2005.

(ii) Under paragraph (e)(1) of this section, the amounts paid by Q to its investment banker that are not inherently facilitative and that are paid for activities performed prior to August 5, 2005 (the date Q's board of directors approves the transaction), are not amounts paid to facilitate the acquisition of P. Amounts paid by Q to its investment banker for activities performed on or after August 5, 2005, and

amounts paid by Q to its investment banker that are inherently facilitative amounts within the meaning of paragraph (e)(2) of this section are required to be capitalized under this section.

Example 17. Stock distribution. Z corporation distributes natural gas throughout state Y. The federal government brings an antitrust action against Z seeking divestiture of certain of Z's natural gas distribution assets. As a result of a court ordered divestiture, Z and the federal government agree to a plan of divestiture that requires Z to organize a subsidiary to receive the divested assets and to distribute the stock of the subsidiary to its shareholders. During 2005, Z pays \$300,000 to various independent contractors for the following services: studying customer demand in the area to be served by the divested assets, identifying assets to be transferred to the subsidiary, organizing the subsidiary, structuring the transfer of assets to the subsidiary to qualify as a tax-free transaction to Z, and distributing the stock of the subsidiary to the stockholders. Under paragraph (c)(3) of this section, Z is not required to capitalize any portion of the \$300,000 payments.

Example 18. Bankruptcy reorganization. (i) X corporation is the defendant in numerous lawsuits alleging tort liability based on X's role in manufacturing certain defective products. X files a petition for reorganization under Chapter 11 of the Bankruptcy Code in an effort to manage all of the lawsuits in a single proceeding. X pays its outside counsel to prepare the petition and plan of reorganization, to analyze adequate protection under the plan, to attend hearings before the Bankruptcy Court concerning the plan, and to defend against motions by creditors and tort claimants to strike the taxpayer's plan.

(ii) X's reorganization under Chapter 11 of the Bankruptcy Code is a reorganization within the meaning of paragraph (a)(4) of this section. Under paragraph (c)(4) of this section, amounts paid by X to its outside counsel to prepare, analyze or obtain approval of the portion of X's plan of reorganization that resolves X's tort liability do not facilitate the reorganization and are not required to be capitalized, provided that such amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. All other amounts paid by X to its outside counsel for the services described above (including all amounts paid to prepare the bankruptcy petition) facilitate the reorganization and must be capitalized.

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

(n) *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.* 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.

Par. 5. Section 1.446-5 is added to read as follows:

§1.446-5 Debt issuance costs.

(a) *In general.* This section provides rules for allocating debt issuance costs over the term of the debt. For purposes of this section, the term *debt issuance costs* means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under §1.263(a)-5. If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under paragraph (b) of this section.

(b) *Method of allocating debt issuance costs — (1) In general.* Solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See §1.1273-2 to determine issue price. Thus, debt issuance costs increase or create original issue discount and decrease or eliminate bond issuance premium.

(2) *Original issue discount.* Any resulting original issue discount is taken into account by the issuer under the rules in §1.163-7, which generally require the use of a constant yield method (as described in §1.1272-1) to compute how much original issue discount is deductible for a period. However, see §1.163-7(b) for special rules that apply if the total original issue discount on the debt is *de minimis*.

(3) *Bond issuance premium.* Any remaining bond issuance premium is taken into account by the issuer under the rules of §1.163-13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

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

Example 1. (i) On January 1, 2004, X borrows \$10,000,000. The principal amount of the loan (\$10,000,000) is repayable on December 31, 2008, and payments of interest in the amount of \$500,000 are due on December 31 of each year the loan is outstanding. X incurs debt issuance costs of \$130,000 to facilitate the borrowing.

(ii) Under §1.1273-2, the issue price of the loan is \$10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of \$130,000, resulting in an issue price of \$9,870,000. As a result, X treats the loan as having original issue discount in the amount of \$130,000 (stated redemption price at maturity of \$10,000,000 minus the issue price of \$9,870,000). Because this amount of original issue discount is more than the *de minimis* amount of original issue discount for the loan determined under §1.1273-1(d) (\$125,000 (\$10,000,000 x .0025 x 5)), X must allocate the original issue discount to each year based on the constant yield method described in §1.1272-1(b). See §1.163-7(a). Based on this method and a yield of 5.30%, compounded annually, the original issue discount is allocable to each year as follows: \$23,385 for 2004, \$24,625 for 2005, \$25,931 for 2006, \$27,306 for 2007, and \$28,753 for 2008.

Example 2. (i) Assume the same facts as in *Example 1*, except that X incurs debt issuance costs of \$120,000 rather than \$130,000.

(ii) Under §1.1273-2, the issue price of the loan is \$10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of \$120,000, resulting in an

issue price of \$9,880,000. As a result, X treats the loan as having original issue discount in the amount of \$120,000 (stated redemption price at maturity of \$10,000,000 minus the issue price of \$9,880,000). Because this amount of original issue discount is less than the *de minimis* amount of original issue discount for the loan determined under §1.1273-1(d) (\$125,000), X does not have to use the constant yield method described in §1.1272-1(b) to allocate the original issue discount to each year. Instead, under §1.163-7(b)(2), X can choose to allocate the original issue discount to each year on a straight-line basis over the term of the loan or in proportion to the stated interest payments (\$24,000 each year). X also could choose to deduct the original issue discount at maturity of the loan. X makes its choice by reporting the original issue discount in a manner consistent with the method chosen on X's timely filed federal income tax return for 2004. If X wanted to use the constant yield method, based on a yield of 5.279%, compounded annually, the original issue discount is allocable to each year as follows: \$21,596 for 2004, \$22,736 for 2005, \$23,937 for 2006, \$25,200 for 2007, and \$26,531 for 2008.

(d) *Effective date.* This section applies to debt issuance costs paid or incurred for debt instruments issued on or after December 31, 2003.

(e) *Accounting method changes* — (1) *Consent to change.* An issuer required to change its method of accounting for debt issuance costs to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446-1(e). Paragraph (e)(2) of this section provides the Commissioner's automatic consent for certain changes.

(2) *Automatic consent.* The Commissioner grants consent for an issuer to change its method of accounting for debt

issuance costs incurred for debt instruments issued on or after December 31, 2003. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (e)(2) applies provided—

(i) The change is made to comply with this section;

(ii) The change is made for the first taxable year for which the issuer must account for debt issuance costs under this section; and

(iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In §602.101, paragraph (b) is amended by adding an entry in numerical order for §1.263(a)-5 to read as follows:

§602.101 OMB Control numbers.

* * * * *
(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.263(a)-5.....	1545-1870
* * * * *	

Mark E. Matthews,
Deputy Commissioner for
Services and Enforcement.

Approved December 19, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 31, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 5, 2004, 69 F.R. 435)

Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401(a)(4)-1: Nondiscrimination requirements of section 401(a)(4).

Whether the application of section 410(b)(6)(C) of the Code to a defined benefit plan causes that defined benefit plan to fail the nondiscrimination requirements of section 1.401(a)(4)-1(b)(2) of the In-

come Tax Regulations. See Rev. Rul. 2004-11, page 480.

26 CFR 1.401(a)(31)-1: Requirement to offer direct rollover of eligible rollover distributions.

If the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover. See Rev. Proc. 2004-14, page 489.

(Also, §§ 402, 403, 408, 457.)

Plan qualification; rollovers. This ruling describes a situation where an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan. As a result, distributions of those amounts are not subject to the restrictions on permissible timing that apply, under the applicable requirements of the Code, to distributions of other amounts from the plan.

Rev. Rul. 2004-12

ISSUE

If an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan, are distributions of those amounts subject to the restrictions on permissible timing that apply, under the applicable requirements of the Internal Revenue Code, to distributions of other amounts from the plan?

LAW AND ANALYSIS

Portability

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. 107-16, certain restrictions applied to rollovers by individuals of funds accumulated in retirement plans maintained by their employers or in IRAs maintained by the individuals. Sections 641 through 643 of EGTRRA (as amended by § 411 of the Job Creation and Worker Assistance Act of 2002, Pub. L. 107-147) substantially increased the rollover opportunities available to individuals, by expanding both the types of plans eligible to accept rollovers and the types of funds that can be rolled over. Rules applicable to rollovers (including the new

portability rules) are contained in the following sections of the Code:

(1) Section 402(c) provides that if any amount paid from a qualified trust in an eligible rollover distribution is transferred to an eligible retirement plan in a rollover that meets the requirements of that section, the amount transferred is not includible in gross income for the taxable year in which paid. Similar rules apply to § 403(a) annuity plans, § 403(b) tax-sheltered annuities, IRAs and § 457 eligible governmental plans.

(2) Section 402(c)(2) provides that the portion of an eligible rollover distribution that would otherwise not be includible in gross income cannot be rolled over unless such previously taxed amounts are transferred either (i) in a direct trustee-to-trustee transfer to a defined contribution plan qualified under § 401(a) that agrees to separately account for such amounts or (ii) to an IRA.

(3) Section 401(a)(31) requires that a qualified trust provide for the direct trustee-to-trustee transfer (a "direct rollover") of eligible rollover distributions. In the case of previously taxed amounts, the limitations described in the preceding paragraph apply. Similar rules apply to § 403(a) annuity plans, § 403(b) tax-sheltered annuities and § 457 eligible governmental plans. (See §§ 403(a)(5), 403(b)(10) and 457(d)(1)(C).)

(4) Section 408(d)(3)(A) provides that previously taxed amounts distributed from an IRA may only be rolled over to another IRA.

(5) Section 402(c)(10) provides that a § 457 eligible governmental plan may not accept a rollover from another type of eligible retirement plan unless it separately accounts for such rollover. Section 72(t)(9) provides that a distribution from such separate account is subject to the 10-percent additional tax under § 72(t) as if the distribution were from a plan described in § 401(a).

(6) Section 402(f) requires that the recipient of an eligible rollover distribution be apprised of the fact that, if the distribution is rolled over to an eligible retirement plan, distributions from such eligible retirement plan may be subject to restrictions and tax consequences that are different from those applicable to distributions from the plan making the eligible rollover distribution. (See § 402(f)(1)(E).)

Distribution Rules Applicable to Rollovers

In many instances, the Code, or Income Tax Regulations or other guidance issued by the Service, provides explicitly for the treatment of rollover contributions. For example, the survivor annuity requirements of §§ 401(a)(11) and 417 apply to all "benefits provided under a plan, including benefits attributable to rollover contributions" (§ 1.401(a)-20, Q&A-11). Similarly, pursuant to § 411(a)(11)(D), in determining whether an employee's accrued benefit exceeds \$5,000 (and thus may not be immediately distributed without the consent of the employee), a plan may provide that rollover contributions (and attributable earnings) are disregarded.

In other instances, rollovers are implicitly included. For example, § 72(t) imposes a 10-percent additional tax on a taxpayer who receives "any amount" from a qualified retirement plan (within the meaning of § 4974(c)) except as otherwise provided in § 72(t); the reference to "any amount" and the lack of an exception for amounts attributable to rollover contributions indicate that § 72(t) is applied without regard to whether the amounts distributed are attributable to rollover contributions.

The rules restricting the timing of distributions, other than those relating to required minimum distributions under § 401(a)(9), generally apply to employer contributions made to the plan or annuity. For example, §§ 401(k)(2)(B) and 403(b)(11) prohibit the distribution of employer contributions that are elective deferrals (within the meaning of § 402(g)(3)) prior to the occurrence of certain events. Section 403(b)(7)(A)(ii) provides that employer contributions to custodial accounts treated as § 403(b) tax-sheltered annuities may not be distributed prior to the occurrence of certain events. Section 457(d)(1)(A) provides generally that an eligible plan meets the distribution requirements of § 457(d) if under the plan amounts will not be made available to participants or beneficiaries earlier than the calendar year in which the participant attains age 70½ or when the participant has a severance from employment. Similarly, regulations under § 401 provide general rules regarding the timing of distributions of employer contributions to pension, profit-sharing and stock bonus plans (see

§ 1.401-1(b)(1)(i), (ii) and (iii)). Thus, § 1.401-1(b)(1)(i) provides that a pension plan is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. The Service has interpreted this to mean that employer contributions to a pension plan may not be distributed prior to retirement, death, disability or other severance from employment, or termination of the plan.

Rev. Rul. 69-277, 1969-1 C.B. 116, and Rev. Rul. 94-76, 1994-2 C.B. 46, address distributions of other types of contributions. Rev. Rul. 69-277 provides that a pension plan may permit distribution to an employee of amounts attributable to the employee's after-tax contributions prior to the employee's termination of employment. Rev. Rul. 94-76 provides that a profit-sharing plan may permit the immediate distribution of amounts attributable to a rollover.

Based on the foregoing, eligible retirement plans that separately account for amounts attributable to rollover contributions may permit the distribution of amounts attributable to an individual's rollover, at any time, pursuant to the individual's request (with spousal consent, if applicable to the plan).

In contrast to rollovers, Rev. Rul. 94-76 and Rev. Rul. 2002-42, 2002-2 C.B. 76, provide that, in the case of a § 414(l) transfer between dissimilar § 401(a) plans (or a plan amendment treated as such a transfer), the characteristics of the transferor plan continue to apply to the transferred assets held in the transferee plan. Thus, when employees' accounts in an employer's money purchase pension plan are transferred to the employer's profit-sharing plan, the transferred assets remain subject to the rules applicable to distributions from a money purchase pension plan: for example, they may not be distributed prior to retirement, death, disability or other severance from employment, or termination of the plan, even though other assets in the plan may be distributed earlier. Similarly, pursuant to § 401(a)(11)(B), a defined contribution plan not otherwise subject to the survivor annuity requirements of §§ 401(a)(11) and 417 is subject to such requirements if the plan is a transferee of a plan subject

to such requirements. However, if the transferee plan separately accounts for the transferred assets and any income thereon, the survivor annuity requirements only apply with respect to the transferred assets (and income thereon).

In the case of § 403(b) tax-sheltered annuities, Rev. Rul. 90-24, 1990-1 C.B. 97, provides that an amount directly transferred from an annuity subject to the early distribution restrictions of § 403(b)(7) or (11) to an annuity not otherwise subject to such restrictions is not treated as a distribution if the transferred amount continues to be subject to the early distribution restrictions of § 403(b)(7) or (11), respectively. In the case of plan-to-plan transfers between § 457 eligible governmental plans, § 1.457-10(b)(6) provides that an amount transferred is subject to the distribution restrictions of the receiving plan in the same manner as if the transferred amount had originally been deferred under the receiving plan if the participant is performing services for the entity maintaining the receiving plan.

HOLDING

If an eligible retirement plan separately accounts for amounts attributable to rollover contributions to the plan, distributions of those amounts are not subject to the restrictions on permissible timing that apply, under the applicable requirements of the Internal Revenue Code, to distributions of other amounts from the plan. Accordingly, the plan may permit the distribution of amounts attributable to rollover contributions at any time pursuant to an individual's request.

Thus, for example, if the receiving plan is a money purchase pension plan and the plan separately accounts for amounts attributable to rollover contributions, a plan provision permitting the in-service distribution of those amounts will not cause the plan to fail to satisfy the requirements of § 1.401-1(b)(1)(i). Similarly, if the receiving plan is a § 457 eligible governmental plan or a tax-sheltered annuity described in § 403(b)(7) or (11), amounts attributable to rollovers that are maintained in separate accounts are permitted to be distributed at any time even though distribution of other amounts under the plan or contract is restricted pursuant to § 457(d)(1)(A) and § 403(b)(7) or (11), respectively.

However, a distribution of amounts attributable to a rollover contribution is subject to the survivor annuity requirements of §§ 401(a)(11) and 417, the minimum distribution requirements of § 401(a)(9), and the additional income tax on premature distributions under § 72(t), as applicable to the receiving plan. Thus, for example, if a distribution from an IRA is rolled over into a plan described in § 401(a), any distribution from the § 401(a) plan of amounts attributable to the rollover would be subject to the exceptions from the § 72(t) tax that apply to § 401(a) plans and not the exceptions that apply to IRAs.

This holding does not apply to amounts received by a plan as a result of a merger, consolidation or transfer of plan assets under § 414(l), nor to plan-to-plan transfers otherwise permitted between § 403(b) tax-sheltered annuities and between § 457 eligible governmental plans.

DRAFTING INFORMATION

The principal author of this revenue ruling is Roger Kuehnle of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Kuehnle may be reached at 202-283-9888 (not a toll-free number).

Section 402.—Taxability of Beneficiary of Employees' Trust

Whether amounts are eligible for rollover distributions. See Rev. Rul. 2004-12, page 478.

If the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover. See Rev. Proc. 2004-14, page 489.

Section 403.—Taxation of Employee Annuities

Whether amounts attributable to rollovers that are accounted for separately are subject to the plan's gen-

eral distribution requirements. See Rev. Rul. 2004-12, page 478.

Section 408.—Individual Retirement Accounts

Whether amounts attributable to rollovers that are accounted for separately are subject to the IRA's general distribution requirements. See Rev. Rul. 2004-12, page 478.

Section 409.—Qualifications for Tax Credit Employee Stock Ownership Plans

If the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover. See Rev. Proc. 2004-14, page 489.

Section 410.—Minimum Participation Standards

26 CFR 1.410(b)-2: Minimum coverage requirements (after 1993).
(Also, § 401; § 1.401(a)(4)-1.)

Coverage; special rules; request for comments. This ruling describes the application of the special coverage rule for acquisitions and dispositions in section 410(b)(6)(C) of the Code in a situation involving a defined benefit plan and a profit-sharing plan that includes a qualified cash or deferred arrangement under section 401(k)(2). In addition, the ruling holds that a significant change in a plan or in the coverage of a plan during the transition period under section 410(b)(6)(C)(ii) curtails the period effective as of the date of the change and does not make the plan retroactively ineligible to apply section 410(b)(6)(C). Finally, the ruling also asks for comments as to other situations that may arise under section 410(b)(6)(C).

Rev. Rul. 2004-11

ISSUES

(1) Will the plans described below be treated as satisfying the requirements of § 1.401(a)(4)-1(b)(2) of the Income Tax Regulations, relating to nondiscriminatory contributions or benefits, and the requirements of §§ 401(k) and 401(m) of the Internal Revenue Code, as well as the require-

ments of § 410(b), by reason of the special rule in § 410(b)(6)(C) for certain acquisitions or dispositions?

(2) Does a significant change in a plan's coverage during the transition period under § 410(b)(6)(C)(ii) make a plan ineligible for the special rule in § 410(b)(6)(C), or merely curtail the transition period during which the special rule may be applied to the plan?

FACTS

Subsidiary S, which is part of X, a controlled group of corporations under § 414(b), sponsors a defined benefit pension plan and a profit-sharing plan for its employees. Both plans are qualified under § 401(a), and the plan year of each plan is the calendar year. Only employees of S are eligible to participate in the plans. The defined benefit plan would satisfy a nondiscrimination safe harbor under § 1.401(a)(4)-3(b) but for the fact that the plan provides a subsidized early retirement benefit that is not currently available to substantially all employees. For purposes of satisfying the nondiscrimination requirements of § 401(a)(4), the defined benefit plan is therefore restructured into two component plans, as permitted by § 1.401(a)(4)-9(c), one component consisting of all the accruals and other benefits, rights, and features provided to those employees to whom the subsidized early retirement benefit is currently available, and the other component consisting of all the accruals and other benefits, rights, and features provided to those employees to whom the subsidized early retirement benefit is not currently available. Each of the component plans separately satisfies a nondiscrimination safe harbor under § 1.401(a)(4)-3(b) and the other nondiscrimination requirements of § 401(a)(4) and also separately satisfies § 410(b) by satisfying the ratio percentage test of § 1.410(b)-2(b)(2). The profit-sharing plan includes only a qualified cash or deferred arrangement, as defined in § 401(k)(2), and matching contributions that are subject to the nondiscrimination requirements of § 401(m).

On June 22, 2004, all of the stock of S is sold to corporation Y. Immediately before the sale, the defined benefit plan maintained by S satisfies the minimum coverage requirements of § 410(b)

by satisfying the ratio percentage test of § 1.410(b)-2(b)(2), and the qualified cash or deferred arrangement and the matching contribution portion of the profit-sharing plan each satisfy the ratio percentage test. For this purpose, neither plan is aggregated with any other plan, and X does not apply the coverage requirements of § 410(b) on the basis of separate lines of business under § 414(r). In addition, each of the component plans under the defined benefit plan satisfies the nondiscrimination requirements of § 401(a)(4) and the ratio percentage test of § 1.410(b)-2(b)(2) immediately before the sale.

S continues to maintain the profit-sharing plan without change after the sale. S also continues to maintain the defined benefit plan, but amends the plan to significantly change the benefit formula effective April 1, 2005.

LAW

Under § 401(a)(3), a plan is not qualified under section § 401(a) unless it satisfies the minimum coverage requirements of § 410(b) and § 1.410(b)-2. In order to satisfy § 410(b) and § 1.410(b)-2, the group of employees benefiting under a plan must not discriminate in favor of highly compensated employees (within the meaning of § 414(q)). In general, a plan satisfies § 410(b) for a plan year if the plan satisfies either the ratio percentage test in § 1.410(b)-2(b)(2) or the average benefit test in § 1.410(b)-2(b)(3) for the plan year. A plan satisfies the ratio percentage test for a plan year if, for the plan year, the plan benefits a percentage of nonhighly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan. A plan satisfies the average benefit test for a plan year if, for the plan year, the plan satisfies the nondiscriminatory classification test in § 410(b)(2)(A)(i) and § 1.410(b)-4 and the average benefit percentage test in § 410(b)(2)(A)(ii) and § 1.410(b)-5. In general, the average benefit percentage test requires the determination of each employee's employee benefit percentage, based on employer-provided contributions or benefits, under all of the employer's qualified plans.

Section 410(b)(6)(C) provides a special rule for applying the minimum coverage

requirements in situations involving certain acquisitions or dispositions. Under § 410(b)(6)(C), if a person becomes, or ceases to be, a member of a group described in § 414(b), (c), (m), or (o), the requirements of § 410(b) are treated as having been met during the transition period with respect to any plan covering employees of such person or any other member of such group, provided two conditions are met. First, the plan must have satisfied the requirements of § 410(b) immediately before each such change in the members of a group. Second, the coverage under the plan must not significantly change during the transition period (other than by reason of the change in the members of a group) or the plan must meet such other requirements as the Secretary may prescribe. The transition period is defined in § 410(b)(6)(C)(ii) as the period beginning on the date of the change in members of a group and ending on the last day of the first plan year beginning after the date of such change.

For purposes of § 410(b)(6)(C), § 1.410(b)-2(f) provides that the terms “acquisition” and “disposition” refer to an asset or stock acquisition, merger, or other similar transaction involving a change in employer of the employees of a trade or business. Section 1.410(b)-2(f) provides that a plan may be treated as satisfying § 410(b) during the transition period following an acquisition or disposition if the plan satisfies § 410(b) (without regard to § 410(b)(6)(C)) immediately before the acquisition or disposition and there is no significant change in the plan or in the coverage of the plan other than the acquisition or disposition.

Section 1.410(b)-7 provides the definition of plan that applies for purposes of § 410(b). In general, each single plan within the meaning of § 414(l) is a separate plan for purposes of § 410(b), but certain plans must be treated as comprising two or more separate plans, each of which is a single plan for purposes of § 410(b). Under § 1.410(b)-7(c), the portion of a plan that is a “section 401(k) plan” is treated as a separate plan for purposes of § 410(b). (A “section 401(k) plan” is a plan consisting solely of elective contributions described in § 1.401(k)-1(g)(3) under a qualified cash or deferred arrangement described in § 1.401(k)-1(a)(4)(i).) Similarly, the portion of a plan that is a “section

401(m) plan” is treated as a separate plan for purposes of § 410(b). (A “section 401(m) plan” is a plan consisting solely of employee contributions described in § 1.401(m)-1(f)(6) or matching contributions described in § 1.401(m)-1(f)(12), or both.) Thus, in the case of a plan that includes elective contributions and employee or matching contributions, the plan must be disaggregated. The portion of the plan that is a section 401(k) plan and the portion of the plan that is a section 401(m) plan must separately satisfy § 410(b).

In general, for purposes of the ratio percentage test and the nondiscriminatory classification test, an employer may permissively aggregate two or more plans, other than plans that are required to be disaggregated. If the employer does so, the aggregated plans are treated as a single plan for purposes of §§ 410(b) and 401(a)(4).

Under § 401(a)(4), a plan is not qualified under § 401(a) unless the contributions or benefits under the plan do not discriminate in favor of highly compensated employees (within the meaning of § 414(q)). Sections 1.401(a)(4)-1 through 1.401(a)(4)-13 set forth the exclusive rules for determining whether a plan satisfies this requirement. Section 1.401(a)(4)-1(b)(2) requires that either the contributions or the benefits under the plan be nondiscriminatory in amount. Section 1.401(a)(4)-3 contains the rules for determining whether employer-derived benefits under a defined benefit plan are nondiscriminatory in amount. Unless the plan satisfies a nondiscrimination safe harbor under § 1.401(a)(4)-3(b), the plan must satisfy the general test for nondiscrimination in amount of benefits under § 1.401(a)(4)-3(c) for the plan year. However, § 1.401(a)(4)-1(c)(4)(iii) and § 1.401(a)(4)-9(c) allow a plan to be treated as consisting of two or more component plans for purposes of satisfying § 401(a)(4). If each component plan satisfies §§ 401(a)(4) and 410(b) as if it were a separate plan, then the plan is treated as satisfying § 401(a)(4). A component plan consists of all the allocations or accruals and other benefits, rights, and features provided under the plan to a selected group of employees. Every employee must be included in one and only one component plan under a plan for a plan year. The requirement that each component plan

satisfy § 410(b) is in addition to the requirement that the plan satisfy § 410(b). Section 1.401(a)(4)-1(c)(4)(iv) provides that, except as otherwise specifically provided, references to satisfying § 410(b) in the regulations under § 401(a)(4) mean satisfying § 1.410(b)-2, taking into account any special rules available in satisfying that section (other than the permissive aggregation rules of § 1.410(b)-7(d)).

Section 401(k)(1) provides that a profit-sharing or stock bonus plan does not fail to be qualified under § 401(a) merely because the plan includes a qualified cash or deferred arrangement. Section 401(k)(3)(A)(i) provides that a cash or deferred arrangement is not a qualified cash or deferred arrangement unless those employees eligible to benefit under the arrangement satisfy the provisions of § 410(b)(1). (This requirement corresponds to the requirement in § 1.410(b)-7(c) that a section 401(k) plan must separately satisfy § 410(b).) Section 401(k)(3)(A)(ii) provides that a cash or deferred arrangement is not a qualified cash or deferred arrangement unless the arrangement satisfies the actual deferral percentage (ADP) test described therein.

Section 401(m) provides special nondiscrimination requirements for employee and matching contributions under a qualified defined contribution plan. Section 401(m)(1) provides that the amount of employee and matching contributions under a defined contribution plan satisfies the requirements of § 401(a)(4) only if the employee and matching contributions under the plan satisfy the actual contribution percentage (ACP) test described in § 401(m)(2).

ANALYSIS

The sale of S to Y is an acquisition or disposition within the meaning of § 1.410(b)-2(f), and the defined benefit plan and each of the disaggregated portions of the profit-sharing plan satisfy § 410(b) (without regard to § 410(b)(6)(C)) immediately before the acquisition or disposition. The sale would affect the data required to be taken into account in applying the requirements of § 410(b) to the plans in the absence of the special rule in § 410(b)(6)(C).

There is no significant change in the section 401(k) plan or in the coverage of

the section 401(k) plan (other than the acquisition or disposition) during the transition period under § 410(b)(6)(C)(ii). Likewise, there is no significant change in the section 401(m) plan or in the coverage of the section 401(m) plan. Therefore, the special rule in § 410(b)(6)(C) may be applied to each of the disaggregated portions of the profit-sharing plan for the transition period starting on the date of sale of S to Y (June 22, 2004) and continuing through December 31, 2005 (that is, the last day of the plan year beginning on January 1, 2005). Accordingly, under § 410(b)(6)(C), the profit-sharing plan will be treated as satisfying the requirements of § 410(b) during the transition period.

The coverage requirement for a qualified cash or deferred arrangement in § 401(k)(3)(A)(i) requires the group of employees eligible to benefit under the arrangement to satisfy § 410(b). Therefore, the special rule for certain acquisitions or dispositions in § 410(b)(6)(C) and § 1.410(b)-2(f) may be applied for purposes of satisfying that requirement. Accordingly, the cash or deferred arrangement in the profit-sharing plan will be treated as satisfying the coverage requirement in § 401(k)(3)(A)(i) during the transition period.

On the other hand, the ADP test and ACP test described in § 401(k)(3)(A)(ii) and § 401(m)(2), respectively, do not refer to § 410(b). Rather, these tests require the comparison of the average of the actual deferral ratios and actual contribution ratios of the group of eligible highly compensated employees and the group of eligible nonhighly compensated employees under the plan. Therefore, the special rule for certain acquisitions or dispositions in § 410(b)(6)(C) and § 1.410(b)-2(f) does not apply for purposes of satisfying the ADP test or the ACP test and thus provides no relief from satisfying these tests using the averages of the actual deferral ratios and actual contribution ratios, respectively, of the eligible employees under the plan. Accordingly, the cash or deferred arrangement and the matching contributions under the profit-sharing plan must satisfy the ADP test and the ACP test following the sale of S to Y using these ratios.

The benefit formula in the defined benefit plan does not satisfy a nondiscrimination safe harbor because the plan provides a subsidized early retirement benefit that

is not currently available to substantially all employees. However, for purposes of satisfying § 401(a)(4), the plan is restructured, as permitted by § 1.401(a)(4)-9(c), into two component plans each of which separately satisfies a nondiscrimination safe harbor. Section 1.401(a)(4)-9(c) requires that each component plan separately satisfy § 410(b) as well as § 401(a)(4). Pursuant to § 1.401(a)(4)-1(c)(4)(iv), the requirements of § 410(b) are to be applied to the component plans taking into account any special rules available in satisfying § 1.410(b)-2 (other than the permissive aggregation rules of § 1.410(b)-7(d)). Thus, for purposes of satisfying the requirements of § 1.401(a)(4)-9(c), the special rule in § 410(b)(6)(C) and § 1.410(b)-2(f) may be applied, provided (1) each component plan separately satisfies §§ 401(a)(4) and 410(b) immediately before the acquisition or disposition and (2) neither the plan nor the coverage under the plan is significantly changed during the transition period (other than by reason of the change in the members of a group) or the plan meets such other requirements as the Secretary may prescribe.

Each component plan under the defined benefit plan separately satisfies §§ 401(a)(4) and 410(b) immediately before the sale of S to Y, and there is no significant change in the defined benefit plan or in the coverage under the defined benefit plan (other than the acquisition or disposition) during the period following the sale and prior to April 1, 2005.

The plan amendment significantly changing the benefit formula in the defined benefit plan, effective April 1, 2005, is a significant change in the plan or in the coverage of the plan (other than the acquisition or disposition) for purposes of § 410(b)(6)(C) and § 1.410(b)-2(f). For this purpose, a change in the plan means a change in the benefits or in the benefit levels under the plan.

The effect of § 410(b)(6)(C) is to provide time for a plan sponsor to consider what coverage or other plan changes will need to be made for the sponsor's plans to continue to satisfy the minimum coverage requirements following an acquisition or disposition. Thus, the plan sponsor is relieved from having to immediately amend its plans or otherwise effect coverage changes to comply with § 410(b). The rule in § 410(b)(6)(C) is permissive, so that

plan sponsors may choose to satisfy the requirements of § 410(b) after an acquisition or disposition either with or without regard to § 410(b)(6)(C). Furthermore, the transition period described in § 410(b)(6)(C)(ii) is the maximum period allowed to a plan sponsor before the sponsor must take into account the change in the employer resulting from the acquisition or disposition. There is no requirement to apply the relief in § 410(b)(6)(C) for the whole of the allowable transition period. Thus, the effect of a significant change in a plan or in the coverage of a plan (other than the acquisition or disposition) during the transition period under § 410(b)(6)(C)(ii) is to curtail the period effective as of the date of the change and not to make the plan retroactively ineligible to apply § 410(b)(6)(C). Accordingly, under § 410(b)(6)(C), the defined benefit plan will be treated as satisfying the requirements of § 410(b) and the requirements of § 1.401(a)(4)-1(b)(2) during the applicable transition period from June 22, 2004, through March 31, 2005.

Starting April 1, 2005, the defined benefit plan must satisfy the requirements of § 410(b) and the requirements of § 1.401(a)(4)-1(b)(2) without regard to the special rule in § 410(b)(6)(C). That is, the plan must satisfy these requirements taking into account the employees of Y. The profit-sharing plan must satisfy the requirements of §§ 410(b) and 401(k)(3)(A)(i) taking into account the employees of Y starting the first day of the plan year beginning on January 1, 2006. The plan amendment significantly changing the benefit formula in the defined benefit plan does not curtail the profit-sharing plan's transition period under § 410(b)(6)(C)(ii) because the plans satisfy the requirements of § 410(b) independently of each other.

HOLDINGS

ISSUE (1)

Under the facts set forth, the defined benefit plan will be treated as satisfying the requirements of § 410(b) and the requirements of § 1.401(a)(4)-1(b)(2) during the applicable transition period from June 22, 2004, through March 31, 2005. The profit-sharing plan will be treated as satisfying the minimum coverage requirements of § 410(b) by reason of the special

rule in § 410(b)(6)(C) during the plan's applicable transition period from the date of the sale through December 31, 2005. The cash or deferred arrangement will also be treated as satisfying the coverage requirement of § 401(k)(3)(A)(i) during this transition period. However, the cash or deferred arrangement and the matching contributions under the profit-sharing plan will not, by reason of the special rule in § 410(b)(6)(C), be treated as satisfying the ADP test or the ACP test in § 401(k)(3)(A)(ii) and § 401(m)(2), and, therefore, the plan must satisfy these tests for the plan years ending on December 31, 2004, and December 31, 2005.

ISSUE (2)

A significant change in a plan or in the coverage of a plan curtails the transition period under § 410(b)(6)(C)(ii), so that § 410(b)(6)(C) ceases to apply to the plan as of the date of the change. The change does not make the plan retroactively ineligible to apply § 410(b)(6)(C).

REQUEST FOR COMMENTS

The facts in this revenue ruling describe only one of many situations that may involve the application of the special rule for acquisitions and dispositions in § 410(b)(6)(C). Different types of transactions or different fact patterns may raise questions other than those addressed in this revenue ruling or may require different analyses. The Service and the Treasury are considering issuing additional guidance regarding § 410(b)(6)(C) of a more comprehensive nature and invite public comments. Comments are invited on the issues on which guidance is needed and on the appropriate resolution of these issues.

Commentators are specifically asked to comment on what the appropriate analysis would be if the facts of the ruling were changed as in the situations described below. In commenting on these situations, commentators are asked to address:

- the requirement in § 410(b)(6)(C)(i)(I) (*i.e.*, that the plan satisfy § 410(b) immediately prior to the acquisition or disposition), and
- the requirement in § 410(b)(6)(C)(i)(II) (*i.e.*, that coverage under the plan not

be significantly changed during the transition period), including how each of these two requirements applies with respect to the seller, the transferred employees, and the buyer in each situation; and

- whether, without creating a potential for abuse, there are appropriate circumstances where a plan that is required to calculate employee allocation or accrual rates or employee benefit percentages to determine that the requirements of § 401(a)(4) or § 410(b) (*e.g.*, the general test or the average benefit percentage test) are satisfied should be treated as satisfying those requirements during the transition period following a § 410(b)(6)(C) acquisition or disposition.

In the following situations, assume that the defined benefit plan sponsored by S (Plan A) provides a benefit of one percent of compensation per year of service and that S does not sponsor a profit-sharing plan. Otherwise, the facts are the same as in the revenue ruling except as described in each of the three situations.

Situation 1: Effect of Transaction if Part of Seller's Plan is Spun-off and is Maintained by Buyer. At the time of the sale of S to Y, Plan A covers other employees of group X as well as employees of S. When S is sold to Y, Plan A is split into two plans, Plan A-1 which covers employees of group X who are not employees of S, and Plan A-2, which covers employees of S. Plan A-2 is thus spun off as a separate plan that is maintained by S after the sale of S to Y.

- a. Assume that, had the sale of S to Y not occurred, Plan A-1 would not satisfy § 410(b) without being aggregated with Plan A-2 (or that Plan A-2 would not satisfy § 410(b) without being aggregated with Plan A-1).
- b. Assume that, after the spin-off, a significant change is made to Plan A-2, but the change is not made to Plan A-1.

Commentators are also asked to consider what the analysis would be if, when S is sold to Y, there is no plan spin-off. As a result, the employees of S do not benefit under a plan after the sale.

Situation 2: Effect on Buyer's Plan if Seller's Plan is Assumed by Buyer. S is a division of group X, rather than a subsidiary, and the transaction is the sale of all of the assets and liabilities of division S to Y. In conjunction with the sale, all division S employees become employees of Y. Y also maintains a defined benefit plan (Plan B) that provides a benefit of two percent of compensation for each year of service. Plan A is assumed by Y, so that employees of S continue to accrue benefits at the rate of one percent of compensation per year of service. The other employees of Y do not participate in Plan A, and the employees of S do not participate in Plan B. For purposes of analyzing the application of § 410(b)(6)(C) to Plan B, consider both the situation where the exclusion of the employees of S from Plan B is the result of Plan B's existing terms and the situation where the exclusion is the result of an amendment to Plan B adopted at the time of the sale of S to Y.

Situation 3: Effect on Buyer's Plan if Seller's Plan is Not Assumed by Buyer. The transaction is the same as in Situation 2, the sale of the assets and liabilities of division S to Y and the transfer of division S employees. However, Y does not assume Plan A, and there are three alternative scenarios with respect to the coverage of employees of S under Plan B:

- a. Plan B does not exclude the employees of S. As a result, the employees of S immediately begin to accrue benefits at the rate of two percent of compensation per year of service under Plan B.
- b. Plan B excludes the employees of S. As a result, the employees of S do not benefit under a plan after the sale.
- c. Plan B is amended at the time of the sale of S to Y to provide a benefit of one percent of compensation per year of service to the employees of S, while continuing to provide the two percent benefit formula for the other employees of Y.

The Service also welcomes comments on other situations or other questions relating to the application of § 410(b)(6)(C).

SUBMISSION OF COMMENTS

Comments should be submitted by May 17, 2004, to CC:PA:LPD:RU (Rev. Rul. 2004-11), Room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m., Monday through Friday to CC:PA:LPD:RU (Rev. Rul. 2004-11), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington D.C. Alternatively, comments may be submitted via the Internet at Notice.Comments@irs.counsel.treas.gov. All comments will be available for public inspection.

DRAFTING INFORMATION

The principal authors of this revenue ruling are James Flannery of Employee Plans, Tax Exempt and Government Entities Division, and R. Lisa Mojiri-Azad of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday (a toll-free number). Mr. Flannery may be reached at 1-202-283-9888 (not a toll-free call). Ms. Mojiri-Azad may be reached at 1-202-622-6060 (also not a toll-free call).

Section 411.—Minimum Vesting Standards

26 CFR 1.411(a)-11: Restriction and valuation of distributions.

Significant detriment; defined contribution plan; allocation of expenses. This ruling describes the application of the significant detriment rule in regulations section 1.411(a)-11(c)(2)(i) in relationship to the Department of Labor's Field Assistance Bulletin 2003-3 pertaining to the allocation of expenses in a defined contribution plan.

Rev. Rul. 2004-10

ISSUE

Does a defined contribution plan under which the accounts of former employees are charged a *pro rata* share of the plan's reasonable administrative expenses, but the accounts of current employees are not charged those expenses, fail to satisfy the requirements of § 411(a)(11) of the Internal Revenue Code?

FACTS

Employer X maintains Plan A, a qualified defined contribution plan. Plan A provides that a participant who terminates employment will receive payment of his or her vested account balance under the plan commencing at normal retirement age or, if later, at termination of employment (subject to § 401(a)(9), in the case of a 5 percent owner). The plan permits a participant who terminates employment prior to normal retirement age to elect at any time after termination of employment to receive an immediate distribution of the vested account balance.

Plan A provides that certain administrative expenses, *e.g.*, investment management fees, are to be allocated to the individual accounts of participants and beneficiaries based upon the ratio of each account balance to the total account balances of all participants and beneficiaries. Plan A further provides that the share of these expenses allocable to each participant's and beneficiary's account will be paid from the plan and charged against the account to the extent not paid by the employer. Employer X pays the portion of these expenses allocable to the accounts of current employees, but not those of former employees or their beneficiaries. All of the administrative expenses are proper plan expenses, within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA), and are reasonable with respect to the services to which they relate.

LAW AND ANALYSIS

Section 411(a)(11)(A) sets forth requirements that must be satisfied with respect to certain distributions in order for a plan to be qualified under § 401(a). Under

§ 411(a)(11), if the present value of a participant's nonforfeitable benefit exceeds \$5,000, a plan meets the requirements of § 411(a)(11) only if the plan provides that the benefit may not be immediately distributable without the consent of the participant.

Section 1.411(a)-11(c)(2)(i) of the Income Tax Regulations provides that consent to a distribution is not valid if, under the plan, a significant detriment is imposed on any participant who does not consent to the distribution. That regulation further provides that whether or not a significant detriment is imposed is determined by the Commissioner by examining the particular facts and circumstances.

An allocation of administrative expenses of a defined contribution plan to the individual account of a participant who does not consent to a distribution is not a significant detriment within the meaning of § 1.411(a)-11(c)(2)(i) if that allocation is reasonable and otherwise satisfies the requirements of Title I of ERISA, such as a *pro rata* allocation. Such an allocation does not impose a detriment so significant as to be inconsistent with the deferral rights mandated by § 411(a)(11) because analogous fees would be imposed in the marketplace, either implicitly or explicitly, for a comparable investment outside the plan (*e.g.*, fees charged by an investment manager for an IRA investment). Accordingly, whether or not such expenses are charged to the accounts of current employees, charging such expenses on a *pro rata* basis to the accounts of former employees is not a significant detriment, within the meaning of § 1.411(a)-11(c)(2)(i), that is imposed on a participant who does not consent to a distribution.

On May 19, 2003, the Employee Benefits Security Administration (the EBSA) of the Department of Labor issued Field Assistance Bulletin (FAB) 2003-3 which sets forth guidelines on the allocation of administrative expenses among plan participants in a defined contribution plan. Assuming that the expenses at issue are both proper expenses of the defined contribution plan and reasonable expenses with respect to the services to which they relate, FAB 2003-3 states that, for purposes of Title I of ERISA, certain administrative expenses may be allocated on a *pro rata* basis and certain administrative expenses may

properly be charged to an individual participant rather than allocated among all plan participants.

However, not every method of allocating plan expenses is reasonable and a method that is not reasonable could result in a significant detriment. For example, allocating the expenses of active employees *pro rata* to all accounts, including the accounts of both active and former employees, while allocating the expenses of former employees only to their accounts would not be reasonable since former employees would be bearing more than an equitable portion of the plan's expenses. Accordingly, such an allocation of expenses could be a significant detriment.

Taxpayers are also reminded that the allocation of plan expenses must comply with the nondiscrimination rules of § 401(a)(4). The method of allocating plan expenses is a plan right or feature described under § 1.401(a)(4)–4(e)(3)(i). For example, if, in anticipation of the divorce of a plan participant who is a highly compensated employee, the plan's method of allocating expenses is changed so that the expense of a determination of whether an order constitutes a qualified domestic relations order under § 414(p) ceases to be allocated solely to the account of the participant for whom the expense is incurred, but instead is allocated *pro rata* to all accounts, the timing of such change may cause the plan to fail to satisfy the requirements of § 1.401(a)(4)–1(b)(3) and (4) with respect to the nondiscriminatory availability of benefits, rights and features and with respect to the timing of plan amendments.

HOLDINGS

Plan A does not fail to satisfy the requirements of § 411(a)(11) merely because it charges reasonable plan administrative expenses to the accounts of former employees and their beneficiaries on a *pro rata* basis, but does not charge the accounts of current employees. Plan A also would not fail to comply with the requirements of § 411(a)(11) merely because it charged reasonable plan administrative expenses to the accounts of former employees and their beneficiaries, but not the accounts of current employees, on another reasonable basis that complies with the requirements of Title I of ERISA.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday (a toll-free call). Mr. Rubin may be reached at (202) 283-9888 (not a toll-free call).

Section 412.—Minimum Funding Standards

Procedures with respect to applications for waivers of the minimum funding standards under section 412(d) of the Code and section 303 of ERISA are set forth. See Rev. Proc. 2004-15, page 490.

Section 416.—Special Rules for Top-Heavy Plans

Top-heavy status; special rules. This ruling describes four situations where a non-governmental profit-sharing plan contains a cash or deferred arrangement described in section 401(k) of the Code that provides for safe harbor matching contributions. In the first situation, the ruling holds that the requirements of section 416(g)(4)(H) are met for that year. In the other situations, the ruling holds that the contributions do not meet the requirements of section 416(g)(4)(H).

Rev. Rul. 2004-13

ISSUE

In the situations described below, which plans meet the requirements of § 416(g)(4)(H) of the Internal Revenue Code for the 2004 plan year so that they are not subject to the top-heavy rules in § 416?

FACTS

Situation 1. A nongovernmental profit-sharing plan containing a cash or deferred arrangement ("CODA") described in § 401(k) provides for safe harbor matching contributions that are intended to satisfy the requirements of § 401(k)(12)(B) and otherwise satisfies the requirements

of § 401(k)(12). The plan also permits the employer to make a nonelective contribution for any plan year at the employer's discretion. The nonelective contribution is subject to 5-year vesting described in § 411(a)(2)(A) and is allocated to participants' accounts in the same ratio that each participant's compensation bears to the compensation of all participants. The plan is a calendar-year plan and covers all employees of the employer (including highly compensated employees as defined in § 414(q)) who have 1 year of service and are age 21 or older. Other than elective contributions and the matching contributions, no other contributions are made to the plan for 2004 and there are no forfeitures.

Situation 2. The facts are the same as in Situation 1, except the employer makes a discretionary nonelective contribution to the plan for 2004.

Situation 3. The facts are the same as in Situation 1, except forfeitures occur in 2004 due to the severance from employment of a participant who was not fully vested in amounts attributable to discretionary nonelective contributions made in a prior year. Pursuant to the terms of the plan, forfeitures are allocated to participants' accounts for 2004 in the same manner as nonelective contributions.

Situation 4. The facts are the same as in Situation 1, except employees are permitted to make elective contributions immediately upon commencement of employment but are not eligible for matching contributions until they have completed 1 year of service with the employer.

LAW AND ANALYSIS

Under § 416, a plan that is a top-heavy plan (as defined in § 416(g)) for a plan year must satisfy the vesting requirements of § 416(b) and the minimum benefit requirements of § 416(c) for such plan year. Section 416 does not apply to any governmental plan.

Section 416(g)(4)(H) provides that the term "top-heavy plan" does not include a plan that consists solely of (1) a CODA that meets the requirements of § 401(k)(12) and (2) matching contributions that meet the requirements of § 401(m)(11). Section 416(g)(4)(H), which is effective for years beginning after December 31, 2001, was added to the

Code by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16.

The determination of whether a plan is a top-heavy plan is made on a year-by-year basis. Thus, a plan that satisfies § 416(g)(4)(H) for one plan year may be subject to the top-heavy requirements the next plan year if it does not satisfy § 416(g)(4)(H) for the next plan year.

Section 401(k)(12) and § 401(m)(11) provide design-based safe harbor methods for satisfying the actual deferral percentage ("ADP") nondiscrimination test contained in § 401(k)(3)(A)(ii) and the actual contribution percentage ("ACP") nondiscrimination test contained in § 401(m)(2). Section 401(k)(12) provides that a CODA is treated as satisfying the ADP test if the CODA meets certain contribution and notice requirements. To satisfy the ADP test safe harbor contribution requirement, an employer must make either (1) a nonelective contribution equal to at least 3 percent of each eligible nonhighly compensated employee's compensation ("safe harbor nonelective contribution") or (2) a matching contribution that satisfies certain minimum amount and rate conditions ("safe harbor matching contribution"). Matching contributions do not satisfy § 401(k)(12) or § 401(m)(11) if the rate of matching contributions for a highly compensated employee at any rate of elective contributions is greater than that for a nonhighly compensated employee who is eligible to make elective contributions. Also, a plan does not meet the requirements of § 401(k)(12) if, under the terms of the plan, a nonhighly compensated employee is eligible to make elective contributions but is not eligible to receive either a safe harbor nonelective contribution or a safe harbor matching contribution. Safe harbor nonelective contributions and safe harbor matching contributions must be nonforfeitable when contributed to the plan and subject to withdrawal restrictions.

Section 401(m)(11) provides that a defined contribution plan is treated as satisfying the ACP test for matching contributions if the plan meets the requirements of § 401(k)(12) and in addition meets certain limitations on the amount and rate of matching contributions available under the plan.

In Situation 1, although the plan provides for discretionary nonelective con-

tributions, none are made for 2004 and thus only contributions described in § 401(k)(12) or § 401(m)(11) are made to the plan for that year.

In Situation 2, the employer makes a discretionary nonelective contribution for 2004, a type of contribution that is not described in § 401(k)(12) or § 401(m)(11).

In Situation 3, the allocation of forfeitures to participants' accounts does not satisfy the requirements for safe harbor nonelective contributions under § 401(k)(12).

In Situation 4, under the plan, newly hired nonhighly compensated employees who make elective contributions will not be eligible to receive any matching contributions until they have completed 1 year of service. Since this will result in a greater rate of matching contributions for highly compensated employees than for nonhighly compensated employees, the matching contributions do not satisfy the requirements of § 401(k)(12) (or § 401(m)(11)). Further, since all eligible nonhighly compensated employees under the plan do not receive safe harbor nonelective contributions or safe harbor matching contributions, the matching contributions made under the plan do not satisfy the requirements of § 401(k)(12). However, certain plans that provide for early participation may satisfy the requirements of § 401(k)(12) with respect to the portion of the plan that covers employees who have completed the minimum age and service requirements of § 410(a)(1), while satisfying the ADP test of § 401(k)(3)(A)(ii) for the eligible employees who have not completed the minimum age and service requirements. Unless a plan (within the meaning of § 414(l)) meets the requirements of § 416(g)(4)(H), no portion of the plan will satisfy § 416(g)(4)(H). (See Notice 2000-3, 2000-1 C.B. 413, Q&A-10.)

HOLDINGS

In Situation 1, the plan meets the requirements of § 416(g)(4)(H) and is therefore not subject to the top-heavy rules in § 416 for 2004 because no other contributions are made to the plans other than contributions described in § 401(k)(12) or § 401(m)(11). The plans in Situation 2, Situation 3 and Situation 4 do not meet the requirements of § 416(g)(4)(H) and are

therefore subject to the top-heavy rules in § 416 for 2004.

DRAFTING INFORMATION

The principal author of this revenue ruling is Roger Kuehnle of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Kuehnle may be reached at 1-202-283-9888 (not a toll-free number).

Section 457.—Deferred Compensation Plans of State and Local Governments and Tax-Exempt Organizations

Whether amounts attributable to rollovers that are accounted for separately are subject to the section 457 plan's general distribution requirements. See Rev. Rul. 2004-12, page 478.

Section 894.—Income Affected by Treaty

26 CFR 1.894-1: Income affected by treaty.

Service partnerships. This ruling provides guidance concerning the application of the U.S.-Germany income tax treaty to a nonresident partner in a service partnership that conducts activities in the United States. It makes clear that a nonresident partner is subject to U.S. income tax on his share of income from the partnership to the extent that such income is attributable to the partnership's activities in the United States, without regard to whether the partner performs services in the United States. This ruling also applies to other U.S. income tax treaties that have the same or similar provisions as those in the U.S.-Germany treaty.

Rev. Rul. 2004-3

ISSUE

Whether a nonresident partner in a service partnership that has a fixed base in the United States is subject to U.S. tax on income attributable to that fixed base

under Article 14, Independent Personal Services, of the Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, signed on August 29, 1989, as amended by the Protocol signed on the same date (the "Treaty").

FACTS

P is a service partnership that is organized under the laws of Germany. P has offices in Germany and the United States. Its U.S. office is a fixed base under Article 14 of the Treaty. P is comprised of two partners: A, a nonresident alien individual who is a resident of Germany under Article 4 of the Treaty, and B, a U.S. resident. A performs services solely at P's office in Germany and B performs services solely at P's office in the United States. A and B agree to divide the profits of the partnership equally.

LAW AND ANALYSIS

Under section 701 of the Internal Revenue Code (the "Code"), a partnership is not subject to income tax; rather, the persons carrying on the business of the partnership as partners are liable for income tax in their separate or individual capacities. Code section 702 requires a partner to determine its income tax by separately taking into account its distributive share of the partnership's income. Under section 702(b), the character of an item of income, gain, loss, deduction, or credit is determined as if such item were realized directly from the source from which it was realized by the partnership, or incurred in the same manner as incurred by the partnership. Under Code section 704, a partner's distributive share generally is determined by the partnership agreement unless an allocation under the agreement does not have substantial economic effect.

Under section 875(1) of the Code, a nonresident alien individual who is a partner in a partnership that is engaged in a U.S. trade or business is himself considered to be so engaged. Section 871(b)(1) of the Code provides that a nonresident alien individual is taxable under Code sections 1 or 55 on his taxable income that is

effectively connected with the conduct of a U.S. trade or business.

Section 894(a)(1) states that the provisions of the Code shall be applied to any taxpayer with due regard to any U.S. treaty obligation that applies to such taxpayer. In *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962), the court held that the U.S. permanent establishment of a partnership was attributable to a foreign person that was a limited partner under the 1942 U.S.-Canada income tax treaty. In *Unger v. Commissioner*, 936 F.2d 1316,1319 (D.C. Cir. 1991), the court followed the holding in *Donroy*, noting that it stood for the proposition that the office or permanent establishment of a partnership is, as a matter of law, the office of each of the partners—whether general or limited. See also *Johnston v. Commissioner*, 24 T.C. 920 (1955) (holding that a partnership's permanent establishment is deemed to be a permanent establishment of its partners); Rev. Rul. 90-80, 1990-2 C.B. 170 (same).

Article 14 of the Treaty provides:

1. Income derived by an individual who is a resident of a Contracting State from the performance of personal services in an independent capacity shall be taxable only in that State, unless such services are performed in the other Contracting State and the income is attributable to a fixed base regularly available to the individual in that other State for the purpose of performing his activities.
2. The term "personal services in an independent capacity" includes but is not limited to independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, economists, architects, dentists, and accountants.

Applying Article 14 in the partnership context requires a determination of whether an individual partner in a service partnership who derives income attributable to the fixed base of the service partnership in the other Contracting State is taxable on that income even though the partner does not perform any services in the other Contracting State. Consistent with section 875 and the case law

discussed above, the fixed base of a partnership is attributed to its partners for purposes of applying Article 14 of the Treaty. Accordingly, A is treated as having a fixed base regularly available to him in the United States. A is subject to U.S. net income taxation on his allocable share of income from P to the extent that such income is attributable to the fixed base in the United States without regard to whether A performs services in the United States.

HOLDING

A is treated as having a fixed base regularly available to him in the United States and is subject to U.S. net income taxation on his allocable share of income from P to the extent that such income is attributable to P's fixed base in the United States, without regard to whether A performs services in the United States. This holding also is applicable in interpreting other U.S. income tax treaties that contain provisions that are the same or similar to Article 14 of the Treaty.

DRAFTING INFORMATION

The principal author of this revenue ruling is Nina Chowdhry of the Office of Associate Chief Counsel (International). For further information regarding this revenue ruling, contact Nina Chowdhry at (202) 622-3880 (not a toll-free call).

Section 1361.—S Corporation Defined

If the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover. See Rev. Proc. 2004-14, page 489.

Section 1362.—Election; Revocation; Termination

26 CFR 1.1362-1: Election to be an S Corporation.

If the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover. See Rev. Proc. 2004-14, page 489.

Section 1366.—Pass-Thru of Items to Shareholders

If the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover. See Rev. Proc. 2004-14, page 489.

Section 4975.—Tax on Prohibited Transactions

26 CFR 54.4975-7(b)(10): Put option.

If the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's

IRA in a direct rollover. See Rev. Proc. 2004-14, page 489.

Part III. Administrative, Procedural, and Miscellaneous

Dividends as a Separately Stated Item

Notice 2004-5

Section 772(a)(11) of the Internal Revenue Code provides that, in determining the income tax of a partner of an electing large partnership (ELP), the partner shall take into account separately the partner's distributive share of partnership items (in addition to those listed in § 772(a)(1) through (10)) to the extent that the Secretary determines that the separate treatment of these items is appropriate.

Pursuant to this authority, the Secretary has determined that it is appropriate for a partner of an ELP to take into account separately the partner's distributive share of the partnership's dividends received that are qualified dividend income (QDI) as defined in § 1(h)(11)(B). This requirement to separately account for QDI takes into account the changes in the taxation of QDI under § 302 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752. This requirement is effective for dividends received by a partnership after December 31, 2002.

The principal author of this notice is Bradford R. Poston of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Bradford R. Poston at (202) 622-3060 (not a toll-free call).

26 CFR 1.1362-2: Termination of election. (Also Part I, §§ 401, 402, 409, 1361, 1362, 1366, 4975; 1.401(a)(31)-1; 1.1362-1; 54.4975-7(b)(10).)

Rev. Proc. 2004-14

SECTION 1. PURPOSE

The Treasury Department and the Internal Revenue Service have determined that it is consistent with the purposes of, and policies underlying, employee stock ownership plans (ESOPs) to enable an ESOP to direct certain rollovers of distributions of S corporation stock to an individual retirement plan (IRA) in accordance with a

distributee's election without terminating the corporation's S election. Accordingly, if the requirements of this revenue procedure are satisfied, the Service will accept the position that a corporation's S election is not affected when an ESOP distributes stock of that corporation to a participant's IRA in a direct rollover.

Rev. Proc. 2003-23, 2003-1 C.B. 599, provides that the Service will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock in a direct rollover to an IRA if the terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA, the S corporation actually repurchases the stock, and the other requirements of that revenue procedure are satisfied. This revenue procedure modifies Rev. Proc. 2003-23 by providing that the Service also will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock in a direct rollover to an IRA if the terms of the ESOP require that the S corporation repurchase its stock immediately upon the ESOP's distribution of the stock to the IRA, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA, the ESOP repurchases the stock, and the other terms of this revenue procedure are satisfied.

SECTION 2. BACKGROUND

In 1996, Congress amended § 1361(b)(1)(B) of the Internal Revenue Code to make ESOPs (as defined in § 4975(e)(7)), along with other plans qualified under § 401(a), eligible S corporation shareholders. A fundamental purpose of an ESOP, including an ESOP that holds stock in an S corporation, is to provide participants with equity ownership in the employer corporation through participation in the ESOP, including distributions of employer securities to participants. *See* S. Rep. 94-938 at 180, 1976-3 C.B. 218 (stating that an ESOP "is a technique of corporate finance designed to build beneficial equity ownership of

shares in the employer corporation in its employees").

Section 409(h) generally requires that an ESOP provide for distributions in the form of employer securities. An ESOP meets the requirements of § 409(h)(1)(A) and (B) if a participant who is entitled to a distribution has the right to demand that the participant's benefits be distributed in the form of employer securities and, if the employer securities are not readily tradeable on an established securities market, has a right to require that the employer repurchase the securities under a fair valuation formula. This right is commonly referred to as a "put option." The put option must permit a participant to put the security to the employer in accordance with § 409(h) and § 54.4975-7(b)(10) of the Excise Tax Regulations. However, under no circumstances may the put option bind the ESOP. The put option may grant the ESOP an option to assume the rights and obligations of the employer to repurchase the securities at the time that the put option is exercised.

Section 409(h)(2)(B) provides that an ESOP maintained by an S corporation is permitted to provide for distributions only in cash or for distributions of employer securities subject to a repurchase requirement which meets the requirements of § 409(h)(1)(B).

Under § 401(a)(31) and A-1 of § 1.401(a)(31)-1 of the Income Tax Regulations, a qualified plan, including an ESOP, is required to permit the distributee of any eligible rollover distribution (as defined in § 402(c)(4)) to have the distribution paid in a direct rollover (as defined in A-3 of § 1.401(a)(31)-1) to an eligible retirement plan (as defined in § 402(c)(8)(B)) specified by the distributee. Therefore, an ESOP that holds S corporation stock and permits distributions in the form of employer securities is required to permit participants to elect to have any distribution of S corporation stock that is an eligible rollover distribution be paid in a direct rollover to an eligible retirement plan specified by the distributee, including an IRA. An IRA trustee or custodian, however, is not a permissible S corporation shareholder. *See* §§ 1361(b) and 1361(c)(6).

Under § 409(h)(2)(B), an ESOP that provides for distributions in the form of securities of an employer that is an S corporation is permitted to provide that the S corporation stock included in the distribution is subject to a repurchase requirement. Thus, an ESOP is permitted to provide that any stock in an S corporation that is distributed is subject to immediate repurchase by the S corporation upon a direct rollover of the stock from the ESOP to an IRA.

SECTION 3. SCOPE

This revenue procedure sets forth certain requirements related to an ESOP's distribution of S corporation stock to a participant where the participant elects to have the S corporation stock distributed to an IRA in a direct rollover. If these requirements are satisfied, the Service will accept the position that the distribution does not affect the S corporation's election to be taxed as an S corporation.

SECTION 4. APPLICATION

The Service will accept the position that an S corporation's election is not affected as a result of an ESOP's distribution of S corporation stock where the participant directs that such stock be distributed to an IRA in a direct rollover, provided that:

.01 The terms of the ESOP require that the S corporation repurchase the stock immediately upon the ESOP's distribution of the stock to an IRA;

.02 Either, pursuant to the terms of the ESOP, the S corporation actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution, or, pursuant to the terms of the ESOP, the ESOP is permitted to assume the rights and obligations of the S corporation to repurchase the S corporation stock immediately upon the ESOP's distribution of the stock to an IRA and the ESOP actually repurchases the S corporation stock contemporaneously with, and effective on the same day as, the distribution; and

.03 No income (including tax-exempt income), loss, deduction, or credit attributable to the distributed S corporation stock under § 1366 is allocated to the participant's IRA.

SECTION 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2003-23 is modified and superseded.

SECTION 6. DRAFTING INFORMATION

The principal authors of this revenue procedure are Audrey W. Ellis of the Office of Associate Chief Counsel (Passthroughs and Special Industries), John Ricotta of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Robert Gertner of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding the S corporation aspects of the revenue procedure, contact Ms. Ellis at (202) 622-3060 (not a toll-free call). For further information regarding the employee plans aspects of the revenue procedure, contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free call) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday or contact Mr. Gertner at (202) 283-9888 (not a toll-free call).

26 CFR 601.201: Rulings and determination letters. (Also Part I, § 412.)

Rev. Proc. 2004-15

SECTION 1. PURPOSE

The purpose of this revenue procedure is to outline the procedures of the Internal Revenue Service with respect to applications for waivers of the minimum funding standard under either § 412(d) of the Internal Revenue Code or section 303 of the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 1974-3 C.B. 1, 41.

SECTION 2. REQUESTS FOR WAIVERS OF THE MINIMUM FUNDING STANDARD FOR DEFINED BENEFIT PLANS

.01 Submission.—Requests for waivers of the minimum funding standard for defined benefit plans must be submitted to:

Employee Plans
Internal Revenue Service
Commissioner, TE/GE
Attention: SE:T:EP:RA
P.O. Box 27063
McPherson Station
Washington, D.C. 20038

The user fee required by Rev. Proc. 2004-8, 2004-1 I.R.B. 240, or its successors, must be sent with such requests.

.02 Necessary Procedural Documents.—A request will not be considered unless it complies with (1) through (5) below.

(1) The request must be signed by the taxpayer maintaining the plan (hereinafter referred to as "applicant") or an authorized representative of the applicant who either must be identified in (a), (b), or (c) of subsection 9.02(11) of Rev. Proc. 2004-4, 2004-1 I.R.B. 125, or must be an enrolled actuary within the meaning of § 7701(a)(35) of the Code. Where an authorized representative signs the request or will appear before the Service in connection with the request, a Form 2848, *Power of Attorney and Declaration of Representative*, must be submitted with the request. For multiemployer plans, the request must be made by the Board of Trustees (which shall be deemed to be the applicant) or by an authorized representative of the Board of Trustees. An individual is not an authorized representative of the applicant merely on account of being the administrator or trustee of the plan.

(2) The request also must contain a declaration in the following form: "Under the penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented in support of the request are true, correct, and complete." This declaration must be signed by the applicant (e.g., an authorized officer of a corporation). The signature of an individual with a power of attorney will not suffice for the declaration. See section 9.02(13) of Rev. Proc. 2004-4, *supra*, p. 142.

(3) Because a request for a waiver constitutes a request for a ruling, compliance with § 6110 of the Code is also required. Section 601.201 of the Statement of Procedural Rules sets forth the requirements

applicable to requests for rulings and determination letters which are subject to § 6110. Section 601.210(e) furnishes specific instructions to applicants. The applicant must also pay the user fee required by Rev. Proc. 2004-8 or its successors.

The applicant must provide with the request either a statement of proposed deletions and the statutory basis for each proposed deletion, or a statement that no information other than names, addresses, and taxpayer identifying numbers need be deleted.

(4) The applicant must provide a copy of a written notification that an application for a waiver of the minimum funding standard under § 412(d) of the Code has been submitted to the Service. The original of the written notification must bear a signature by an appropriate officer of the applicant and must be in substantially the form set forth in the Model Notice found in the Appendix A to this revenue procedure. The Service does not require the applicant to furnish any information in addition to that required by the Model Notice in the Appendix A to plan participants, beneficiaries, alternate payees, or employee organizations as part of the waiver application process, but additional information may, of course, be provided by the applicant pursuant to the collective bargaining process or otherwise.

The application must state that such notice was hand delivered or mailed to the last known address of each employee organization, participant, beneficiary, and alternate payee (within the meaning of § 414(p)(8) of the Code) within 14 days prior to the date of the application. If the applicant makes a reasonable effort to carry out the provisions of this paragraph, failure of an employee organization, participant, beneficiary, or alternate payee to receive the notice will not cause the applicant to fail the notice requirement. However, merely posting the notice on a bulletin board is not sufficient to satisfy this requirement.

.03 Necessary Waiver Information.—The applicant must furnish appropriate evidence that the employer and all other entities included within the controlled group of which the employer is a member are unable to satisfy the minimum funding standard for a plan year without

temporary substantial business hardship and that application of the standard would be adverse to the interest of plan participants in the aggregate. In the case of a multiemployer plan, the applicant must furnish appropriate evidence that 10 percent or more of the number of employers contributing to or under the plan are unable to satisfy the minimum funding standard for a plan year without substantial business hardship and that application of the standard would be adverse to the interest of plan participants in the aggregate. What constitutes appropriate evidence will depend on the facts and circumstances of each case. A response must be furnished for each of the subsections (1) through (7) below. In certain cases some of the material described in subsections (1) through (7) may be inapplicable, unavailable, inappropriate or burdensome to furnish. In such cases, the applicant should furnish a statement indicating why the material for a particular subsection is inapplicable, unavailable, inappropriate or burdensome.

(1) General facts concerning the employer.

A brief statement should be submitted concerning: (a) the history of the employer and its primary business; (b) the ownership of the employer and any recent or contemplated changes (such as acquisitions, mergers, discontinuances of operations) which might have a bearing on the employer's organization or financial condition; (c) whether the employer is aggregated with any other entity for purposes of §§ 414(b), (c), (m) or (o) of the Code; and (d) whether the plan is also maintained by employers described in (c) above or any other employers.

(2) The financial condition of the employer.

The annual financial report of the employer and each of the other entities included within the controlled group of which the employer is a member for each of the two fiscal years that commenced prior to any plan year for which a waiver is requested and the annual financial report for each fiscal year that commenced with or within each plan year for which a waiver is requested must be submitted. This submission must include at least the balance

sheet, profit and loss statement, cash flow statement, and notes to the financial statement. Recent interim financial reports for each of the controlled group members, if available, should also be submitted along with an interim financial report covering the corresponding period for the previous year. If the employer submits financial reports to the Securities and Exchange Commission, these reports should be submitted for the same periods as the annual financial reports. Preferably, the financial report should include certified financial statements. If certified financial statements have not been prepared, an uncertified report is acceptable. If neither certified nor uncertified reports are available, copies of the company's federal income tax returns, including all of the supporting schedules, must be submitted. (See also paragraph 5.)

(3) Executive compensation arrangements (not required for multiemployer plans)

For each person who is an officer (within the meaning of Q&A T-13 of § 1.416-1 of the Income Tax Regulations) or director of the applicant or any entity aggregated with the applicant for purposes of §§ 414(b), (c), (m), or (o) of the Code ("aggregated entities"), provide a detailed statement concerning all amounts that the applicant or any aggregated entity has paid or will pay to or for the benefit of such person during the plan year for which the request is made and the immediately preceding 24 months. For this purpose, if the number of employees (including part-time employees) of the applicant and all aggregated entities as of the first day of the plan year for which the request is made is: (a) not more than 30, no more than three persons shall be treated as officers; (b) more than 30 but not more than 100, no more than 10% of such employees (rounded to the next integer) shall be treated as officers; or (c) more than 100, no more than 10 of such employees shall be treated as officers. In each case, this limited number of officers shall be comprised of those officers to whom or for whose benefit the applicant and all aggregated entities have paid or will pay the largest such amounts during such period. In addition, provide information concerning amounts paid or to be paid during such period to or for

the benefit of up to five additional persons who are former officers or directors of the applicant or any aggregated entity or who are aggregated with any such former officer or director for purposes of §§ 414(b), (c), (m) or (o) of the Code and who would be included in such limited number of officers if they were officers of the applicant.

The statement should include, among other payments, amounts paid with respect to: (a) salary; (b) non-qualified deferred compensation; (c) fringe benefits, perquisites, and other personal benefits; (d) bonuses and incentive compensation, including amounts deferred from previous periods; (e) money or other property set aside in any trust, escrow, insurance policy, or other similar funding vehicle during the years in question for the benefit of any such person, whether or not included in such person's income; (f) grants of stock options, restricted stock, or other equity compensation; (g) money or other property paid by reason of the exercise of any stock option or stock appreciation right or pursuant to any phantom stock plan or agreement; (h) money or other property paid pursuant to any other long-term incentive plan; (i) loans to or for the benefit of such persons and any loan repayments during such period; (j) money or other property paid in connection with any change in control or termination of employment or service and (k) any other compensation to or for the benefit of such persons that has affected or will affect the cash flow of the applicant or any aggregated entity for such period. Applicants may omit information regarding any plan that satisfies the qualification requirements of § 401(a) of the Code and any other pension, profit sharing, employee stock ownership, employee stock purchase, group life, health, hospitalization, medical reimbursement, fitness or wellness, employee relocation, severance, or similar plan that does not discriminate in scope, terms, or operation in favor of officers or directors of the applicant and that is available generally to all salaried employees.

(4) Nature and extent of the business hardship. An explanation of the nature and extent of the business hardship should include the following.

(a) A discussion of the underlying reasons which have led to the current situation (such as declining sales, unexpected losses, labor disputes, etc.).

(b) A statement concerning the prospects for recovery, including reasons why such recovery is likely.

(c) A statement describing the actions taken or planned to effect recovery.

(d) A statement as to when and to what extent it is anticipated that required contributions to the plan can reasonably be expected to resume.

(e) Financial projections and collateral information for certain employers (not required for multiemployer plans)

If the sum of the outstanding balances of any amortization bases established under § 412(b)(2)(C) of the Code for waivers granted to the plan for any prior plan years (calculated as of the first day of the plan year for which a new waiver is being requested) when added to the amount for which a waiver is currently being requested, equals or exceeds \$1,000,000, items (4)(b) & (c) should be supported by financial projections, for not less than the next five years, for each trade or business of the plan sponsor, along with any supporting text and schedules. These projections should include revenues, expenses, and cash flow statements, along with all major strategic and economic assumptions used in deriving them. The cash flow projections should include capital expenditures, forecasted contributions to the pension plan(s), long-term debt repayments, and any mandatory debt repayments. Any projections based on a significant strategic or financial turnaround should fully explain this turnaround. Also, a brief description should be included of what collateral, if required, would be available to secure any waived contributions.

The Service may request additional information, including items listed in § 412(d)(2) of the Code.

(5) Facts concerning the pension plan. For each pension plan for which a waiver is requested, the following information should be supplied.

(a) The name of the plan, the plan's identification number, and file folder number (if any).

(b) The date the plan was adopted.

(c) The effective date of the plan.

(d) The classes of employees covered. If the only participants are owners of the employer or relatives of owners, so state.

(e) The number of employees covered.

(f) A copy of the current plan document and the most recent summary plan description.

(g) A brief description of all plan amendments adopted during the year for which the waiver is requested and the previous four years which affect plan costs, including the approximate effect of each amendment on such costs.

(h) The most recent actuarial report plus any available actuarial reports for the preceding two plan years. Also, if not shown in that report, the present value of accrued benefits, present value of vested benefits, and fair market value of assets (excluding contributions not yet paid).

(i) How the plan is funded (*i.e.*, trust fund, individual insurance policies, etc.).

(j) A list of the contributions actually paid in each month, from the twenty-fourth month prior to the beginning of the plan year for which the waiver is requested through the date of the request and the plan year to which the contributions were applied, with the employee contributions and the employer contributions listed separately.

(k) The plan year for which the waiver is requested (*e.g.*, 1/1/03-12/31/03).

(l) The approximate contribution required to meet the minimum funding standard and the approximate amount requested to be waived. For defined benefit plans, this amount should be determined by the plan's enrolled actuary.

(m) A copy of the most recently completed *Annual Return/Report of Employee Benefit Plan* (Form 5500 series, as applicable) and in the case of a defined benefit plan, a copy of the corresponding Actuarial Information schedule (Schedule B of Form 5500).

(n) Whether the plan is subject to Title IV of ERISA.

(o) A copy of each ruling letter that waived the minimum funding standard during the last 15 plan years, a statement of the amount waived for each plan year, and a statement of the outstanding balance of the amortization base for each waived funding deficiency. The outstanding balance of the amortization base for each waiver is to be calculated as of the first day of the plan year for which a waiver is being requested.

(6) Other pension, profit-sharing, or stock bonus plans. If the employer maintains more than one plan, an outline of the essential facts for each such plan should be submitted. This should include:

(a) A brief description of the plan, including the name of the plan and its plan year.

(b) The number of employees covered.

(c) The classes of employees covered.

(d) The approximate annual contribution required.

(e) The amount of contributions that have been made, or are intended to be made, for any plan year of such other plan commencing in, or ending in, the plan year for which the waiver is requested.

(f) A statement as to whether a waiver request is contemplated for the plan.

(7) Other information.

(a) Describe the nature of any matters pertaining to the plan which are currently pending or are intended to be submitted to the Service, Department of Labor or the Pension Benefit Guaranty Corporation.

(b) Furnish details of any existing arbitration, litigation, or court procedure which involves the plan.

(c) Also state which Area Office maintains files concerning the plan.

(8) Although it is not required, a digest of certain information from the financial statements described in this section will facilitate the processing of a waiver request. For example, a digest could show for the applicable years:

(a) current assets;

(b) inventory included in current assets;

(c) fixed assets;

(d) other assets;

(e) total assets;

(f) current liabilities;

(g) long-term liabilities;

(h) other liabilities;

(i) total liabilities;

(j) working capital;

(k) equity;

(l) sales;

(m) cost of sales;

(n) gross profit;

(o) other income and expense;

(p) net profit before taxes;

(q) income taxes;

(r) net profit after taxes; and

(s) for plans for which waivers are requested, pension costs expensed in determining (p).

.04 Additional Copy of Information Required.—The applicant must furnish two copies of the necessary waiver information described in section 2.03, if the sum of the outstanding balances of any amortization bases established under § 412(b)(2)(C) of the Code for waivers granted to the plan for any prior plan years (calculated as of

the first day of the plan year for which a new waiver is being requested) when added to the amount for which a waiver is currently being requested, equals or exceeds \$1,000,000.

.05 Checklist.—A checklist has been provided in Appendix B for the convenience of the taxpayer submitting the request. In certain cases some of the material described above may be inappropriate or burdensome to furnish. In such cases, the request for approval should include a statement indicating why such material is not being furnished.

SECTION 3. REQUEST FOR WAIVERS FOR DEFINED CONTRIBUTION PENSION PLANS

.01 Background Information.—Section 3 of Rev. Rul. 78-223, 1978-1 C.B. 125, requires that a defined contribution pension plan contain certain provisions in order for a waiver to be granted. If the applicant does not want to draft individually designed provisions to satisfy the requirements of section 3 of Rev. Rul. 78-223, the Service will provide sample plan amendment language that complies with such requirements. See subsection .02. However, a provision that satisfies section 3 of Rev. Rul. 78-223 does not necessarily satisfy the requirements of § 401(a) of the Code. In order to provide maximum flexibility in obtaining a waiver for a defined contribution pension plan, three alternative procedures are provided in subsections .02, .03, and .04, in which a single request may cover either a waiver ruling only or a waiver ruling and a determination letter as to the status under § 401(a) of the Code.

.02 Waiver Ruling Only/Without Submission of Plan Amendment.—Under this procedure, requests for waivers must be submitted to:

Employee Plans
Internal Revenue Service
Commissioner, TE/GE
Attention: SE:T:EP:RA
P.O. Box 27063
McPherson Station
Washington, D.C. 20038

The applicant must satisfy the requirements of section 2 of this revenue procedure except those applicable only to defined benefit plans, e.g. section 2.03(5)(h).

Any waiver ruling granted under this procedure will be accompanied by a plan amendment supplied by the Service which will, if adopted, satisfy section 3 of Rev. Rul. 78-223. The waiver will be conditioned upon the plan being amended by adoption of that amendment, within a reasonable period of time, and will contain a caveat stating that the ruling is not a ruling as to the effect the plan provision may have on the qualified status of the plan. Upon receipt of that amendment, the applicant may (within 60 days of date of the letter) request reconsideration of this waiver condition if the amendment is inappropriate. Reconsideration may be requested by submitting a letter from the applicant (or authorized representative) to the above address.

.03 Waiver Ruling Only/With Submission of Plan Amendment.—Under this procedure, requests for waivers must be submitted to:

Employee Plans
Internal Revenue Service
Commissioner, TE/GE
Attention: SE:T:EP:RA
P.O. Box 27063
McPherson Station
Washington, D.C. 20038

The applicant must satisfy the requirements of section 2 of this revenue procedure, except those applicable only to defined benefit plans, *e.g.* section 2.03(5)(h), and must include the plan provisions necessary to satisfy section 3 of Rev. Rul. 78-223. All waivers issued pursuant to this subsection will contain a caveat indicating that the ruling is not a ruling as to the effect any plan provision, submitted pursuant to the previous sentence, may have on the qualified status of the plan.

.04 Waiver Ruling and Determination Letter Request.—Under this procedure both the request for a waiver ruling and the request for a determination letter on the effect of any amendment necessary to satisfy section 3 of Rev. Rul. 78-223 must be submitted by the applicant to the Office of the Commissioner, Tax Exempt and Government Entities Division where it will be treated as if it had been submitted as a request for technical advice from the Determinations Manager.

(1) The request that is submitted to the Office of the Commissioner, Tax Exempt and Government Entities Division must include the following:

(a) The combined request must satisfy all the procedural requirements described in section 3.03 of this revenue procedure;

(b) The submission must include a completed Form 5300 and all necessary documents, plan amendments, and information required by the Form 5300 and by this revenue procedure for approval of the plan amendments;

(c) The request must indicate which Area Office has audit jurisdiction over the return; and

(d) The user fee for both the waiver request and the determination letter request must be contained in the submission to the Office of the Commissioner, Tax Exempt and Government Entities Division.

(2) The procedures for notice and comment by interested parties, which are contained in sections 17, 18, and 19, of Rev. Proc. 2004-6, 2004-1 I.R.B. 197, or its successors, as well as the notice and comment procedures provided in section 2.02 of this revenue procedure must be satisfied. Comments are to be forwarded to the Determinations Office that is considering the determination letter request for the plan amendments.

(3) The waiver request will be handled by the Office of the Commissioner, Tax Exempt and Government Entities Division as follows:

(a) The waiver request and supporting documents will be forwarded to the Actuarial Group, SE:T:EP:RA:T:A, which will treat the request as a technical advice on the qualification issue with respect to the plan provisions necessary to satisfy section 3 of Rev. Rul. 78-223.

(b) The appropriate Determinations Office will be notified of the request. In order not to delay the processing of the request, all materials relating to the determination letter request will be sent by the Office of the Commissioner, Tax Exempt

and Government Entities Division to the Determinations Manager for consideration while the technical advice request is completed.

(c) The Office of the Commissioner, Tax Exempt and Government Entities Division will consider both issues. If a waiver is to be granted and if the Office of the Commissioner, Tax Exempt and Government Entities Division believes that qualification of the plan is not adversely affected by the plan amendment, a technical advice memorandum will be issued to the Determinations Manager. The Determinations Manager must decide within 10 working days from the date of the technical advice memorandum either to furnish the applicant with the technical advice memorandum and with a favorable advance determination letter, or to ask for reconsideration of the technical advice memorandum. This request must be in writing. An initial written notice of intent to make this request may be submitted within 10 working days of the date of the technical advice memorandum and followed by a written request within 30 working days from the date of such written notice. If the Determinations Manager does not ask for reconsideration of the technical advice memorandum within 10 working days, the Actuarial Group will issue the waiver ruling. This ruling will not contain the caveat described in section 3.02.

SECTION 4. DEADLINE FOR REQUESTING A WAIVER

All waiver requests (for plans other than multiemployer plans) must be submitted no later than the 15th day of the 3rd month following the close of the plan year for which the waiver is requested. The Service cannot extend this statutory deadline. A request for a waiver with respect to a multiemployer plan generally must be submitted no later than the close of the plan year following the plan year for which the waiver is requested.

In seeking a waiver with respect to a plan year which has not yet ended, the applicant may have difficulty in furnishing sufficient current evidence in support of the request. For this reason it is generally advised that a request not be submitted earlier than 180 days prior to the end

of the plan year for which the waiver is requested.

SECTION 5. GENERAL

Employers who have difficulty in furnishing the information specified in this Revenue Procedure may call the Employee Plans Customer Assistance Service at 1-877-829-5500 (a toll-free number), or write for guidance at the following address:

Internal Revenue Service
Commissioner, TE/GE
Attention: SE:T:EP:RA:T:A
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Additional information sent after the initial request should be sent to the Actuarial Group. In appropriate instances, preliminary conferences may be afforded in addition to conferences available under Rev. Proc. 2004-4, 2004-1 I.R.B. 125.

SECTION 6. BANKRUPTCY PETITIONS

If the applicant or a significant number of controlled group members file a bankruptcy petition after the request for a waiver of the minimum funding standard is submitted to the Service, the applicant must provide to the Service an update to the information required to be submitted in section 2 of this revenue procedure, especially the financial information in section 2.03(4).

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for all ruling requests received after February

17, 2004, the date of its publication in the Internal Revenue Bulletin.

SECTION 8. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2004-4 is modified to the extent that this revenue procedure provides special procedures for issuing rulings with respect to requests for waivers of the minimum funding standard.

Rev. Proc. 2004-5 is modified to the extent that this revenue procedure provides special procedures for furnishing technical advice to Determinations managers when both a request for a waiver of the minimum funding standard and a request for a determination letter have been submitted for a defined contribution plan.

Rev. Proc. 2004-6 is modified to the extent that this revenue procedure provides special procedures to follow in issuing a determination letter for a defined contribution plan if a waiver of the minimum funding standard has been requested.

Rev. Proc. 94-41, 1994-1 C.B. 711, is superseded

SECTION 9. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545-1873.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information in this revenue procedure is in sections 2 and 3. This information is required to evaluate and process the request for a change in funding method. The collection of information is required to obtain approval for a change in funding method. The likely respondents are businesses or other for-profit institutions, nonprofit institutions, and small businesses and organizations.

The estimated total annual reporting burden is 4,730 hours.

The estimated annual burden per respondent varies from 75 to 100 hours, depending on individual circumstances, with an estimated average burden of 86 hours. The estimated number of respondents and/or recordkeepers is 55.

The estimated annual frequency of responses is one.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is John C. Heil of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding how this revenue procedure applies to employee plans matters, contact the Employee Plans Customer Assistance Service at 1-877-829-5500 (a toll-free call). Mr. Heil's telephone number is (202) 283-9694 (not a toll-free call).

APPENDIX A

**MODEL NOTICE OF FUNDING WAIVER APPLICATION
TO EMPLOYEE ORGANIZATIONS (UNIONS),
PARTICIPANTS, BENEFICIARIES, AND ALTERNATE PAYEES**

This notice is to inform you that an application for a waiver of the minimum funding standard under § 412(d) of the Internal Revenue Code (Code) and section 303 of the Employee Retirement Income Security Act of 1974 (ERISA) has been submitted by [INSERT PLAN SPONSOR'S NAME] to the Internal Revenue Service (Service) for the [INSERT PLAN NAME] for the plan year beginning [INSERT DATE].

Under § 412(f)(4)(B) of the Code and section 303(e)(2) of ERISA, the Service will consider any relevant information submitted concerning this application for a waiver of the minimum funding standard. You may send this information to the following address:

Director, Employee Plans
Internal Revenue Service
Attention: SE:T:EP:RA:T:A
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Any such information should be submitted as soon as possible after you have received this notice. Due to the disclosure restrictions of § 6103 of the Code, the Service can not provide any information with respect to the waiver request itself.

In accordance with section 104 of ERISA and § 2520.104b-10 of the Department of Labor Regulations (29 C.F.R. Part 2520), annual financial reports for this plan, which include employer contributions made to the plan and the accumulated funding deficiency for the plan for any plan year, are available for inspection at the Department of Labor in Washington, D.C. Copies of such reports may be obtained upon request and upon payment of copying costs from the following address:

Public Disclosure Room
Room N-5507
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

As required by section 104(b)(2) of ERISA, copies of the latest annual plan report are available for inspection at the principal office of the plan administrator, who is located at [INSERT ADDRESS]. Copies of the annual report may be obtained upon request and upon payment of a copying charge of [INSERT CHARGE] by writing to the plan administrator at the above address.

The following information is provided pursuant to § 412(f)(4)(A) of the Code and section 303(e)(1) of ERISA:

Present Value of Vested Benefits \$_____

Present Value of Benefits, calculated as though the plan terminated \$_____

Fair Market Value of Plan Assets \$_____

The above present values were calculated using an interest rate of [INSERT INTEREST RATE].

[SIGNATURE OF APPROPRIATE OFFICER OF THE PLAN SPONSOR]

[INSERT NAME]

[INSERT TITLE]

APPENDIX B
WAIVER OF MINIMUM FUNDING STANDARD REQUEST CHECKLIST
IS YOUR SUBMISSION COMPLETE?

INSTRUCTIONS

The Service will be able to respond more quickly to your waiver of minimum funding standard request if it is carefully prepared and complete. To ensure your request is in order, use this checklist. Answer each question in the checklist by inserting Y for yes, N for no, or N/A for not applicable, as appropriate, in the blank next to the item. *Sign and date the checklist (as taxpayer or authorized representative) and place it on top of your request.*

You must submit a completed copy of this checklist with your request. If a completed checklist is not submitted with your request, substantive consideration of your submission will be deferred until a completed checklist is received.

- _____ 1. If you want to designate an authorized representative, have you included a properly executed Form 2848 (*Power of Attorney and Declaration of Representative*)?
- _____ 2. Have you satisfied all the requirements of Rev. Proc. 2003-4 or its successors (especially concerning signatures and penalties of perjury statement)? (See section 2.02(1) & (2))
- _____ 3. Have you included statement of proposed deletions? (See §2.02(3))
- _____ 4. Have you included the user fee required under Rev. Proc. 2003-8 or its successors? (See section 2.01 & 2.02(3))
- _____ 5. Have you included a copy of the written notification that an application for a waiver has been submitted and a statement that such notice was delivered to each employee organization, participant, beneficiary and alternate payee? (See section 2.02(4) and Appendix A)
- _____ 6. Have you included the general facts concerning the employer? (See section 2.03(1))
- _____ 7. Have you included a description of the employer's financial condition? (See section 2.03(2)).
- _____ 8. If the plan is not a multiemployer plan, have you included a description of the employer's executive compensation arrangements? (See section 2.03(3))
- _____ 9. Have you included an explanation of the nature and extent of the business hardship, including financial projections if the waiver request exceeds \$1,000,000 and the plan is not a multiemployer plan? (See section 2.03(4))
- _____ 10. Have you included information concerning the pension plan? (See section 2.03(5))
- _____ 11. Have you included information concerning other pension, profit-sharing, or stock bonus plans of the employer? (See section 2.03(6))
- _____ 12. Have you included information concerning other matters pertaining to the plan? (See section 2.03(7))

13. Have you provided a digest of financial information? (See section 2.03(8))

14. Have you provided 2 copies of the necessary waiver information described in section 2.03 if the waiver request exceeds \$1,000,000? (See section 2.04)

15. If the waiver request pertains to a defined contribution pension plan, have you provided a copy of the plan amendment or determination letter request, if applicable? (See section 3.01–3.04)

16. Have you submitted the request for a waiver no later than the 15th day of the 3rd month following the close of the plan year if the plan is not a multiemployer plan, or no later than the close of the plan year following the plan year for which the waiver is requested if the plan is a multiemployer plan? (See section 4)

Signature

Date

Title or Authority

Typed or printed name of person signing checklist

Part IV. Items of General Interest

Announcement of Disciplinary Actions Involving Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries — Suspensions, Censures, Disbarments, and Resignations

Announcement 2004-6

Under Title 31, Code of Federal Regulations, Part 10, attorneys, certified public accountants, enrolled agents, and enrolled actuaries may not accept assistance from, or assist, any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter constituting practice before the Internal Revenue Service and may not knowingly aid or abet another

person to practice before the Internal Revenue Service during a period of suspension, disbarment, or ineligibility of such other person.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify persons to whom these restrictions apply, the Director, Office of Professional Responsibility will announce in the Internal Revenue Bulletin

their names, their city and state, their professional designation, the effective date of disciplinary action, and the period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks.

Disbarments From Practice Before the Internal Revenue Service After Notice and an Opportunity for a Proceeding

Under Title 31, Code of Federal Regulations, Part 10, after notice and an oppor-

tunity for a proceeding before an administrative law judge, the following individu-

als have been disbarred from practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Baxley II, Milton	Gainesville, FL	CPA	October 24, 2003

Consent Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid institution or conclusion of a proceeding for his or her disbarment or suspension from practice be-

fore the Internal Revenue Service, may offer his or her consent to suspension from such practice. The Director, Office of Professional Responsibility, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled ac-

tuary in accordance with the consent offered.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Nietupski, John E.	Springfield, MA	Enrolled Agent	Indefinite from October 15, 2005
Roberts, Dennis C.	Oklahoma City, OK	Attorney	Indefinite from October 27, 2003

Name	Address	Designation	Date of Suspension
Waldo-Grant, Barbara A.	Grand Rapids, MI	Enrolled Agent	Indefinite from November 1, 2003
Naylor, Dale C.	El Cajon, CA	Enrolled Agent	Indefinite from November 12, 2003
Schlude, Richard M.	Wilkes Barre, PA	Enrolled Agent	Indefinite from November 19, 2003
Stern, Samuel L.	Robbinsdale, MN	Attorney	Indefinite from November 19, 2003
Robles, Michael	Dallas, TX	CPA	Indefinite from December 1, 2003
Young Jr., Donald A.	Redondo Beach, CA	Enrolled Agent	December 1, 2003 to August 31, 2004
Hitchcock, William C.	Irvine, CA	Enrolled Agent	Indefinite from December 30, 2003
Willms, Bryant E.	Lee Summit, MO	Enrolled Agent	January 1, 2004 to December 31, 2004

Expedited Suspensions From Practice Before the Internal Revenue Service

Under Title 31, Code of Federal Regulations, Part 10, the Director, Office of Professional Responsibility, is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years from the date

the expedited proceeding is instituted (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause or (2) has been convicted of certain crimes.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions:

Name	Address	Designation	Date of Suspension
Greene, Marvin	Chicago, IL	CPA	Indefinite from October 21, 2003
Bolusky, Eric B.	Perkins, OK	Attorney	Indefinite from October 21, 2003
Crutchfield Jr., Ernest	Latty, OH	Enrolled Agent	Indefinite from October 21, 2003

Name	Address	Designation	Date of Suspension
Covey, Charles	Gladstone, MO	CPA	Indefinite from October 23, 2003
Prosperi, Arnold P.	Jupiter Island, FL	Attorney	Indefinite from November 24, 2003
Lucas, Christopher	Overland Park, KS	Attorney	Indefinite from November 24, 2003
Ramsey, Henry A.	Burnet, TX	CPA	Indefinite from December 15, 2003

Resignations of Enrolled Agents

Under Title 31, Code of Federal Regulations, Part 10, an enrolled agent, in order to avoid the institution or conclusion of a proceeding for his or her disbarment or suspension from practice before the In-

ternal Revenue Service, may offer his or her resignation as an enrolled agent. The Director, Office of Professional Responsibility, in his discretion, may accept the offered resignation.

The Director, Office of Professional Responsibility, has accepted offers of resignation as an enrolled agent from the following individuals:

Name	Address	Date of Resignation
Pettyplace, Edward F.	Sacramento, CA	January 30, 2004

Guidance Under Section 1502; Suspension of Losses on Certain Stock Dispositions; Correction

Announcement 2004-10

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correction to final and temporary regulations.

SUMMARY: This document corrects final and temporary regulations (T.D. 9048, 2003-1 C.B. 644 [68 FR 12287]) published in the **Federal Register** on March 14, 2003. The final and temporary regulations redetermine the basis of stock of a subsidiary member of a consolidated group immediately prior to certain transfers of such stock and certain deconsolidations of a subsidiary member and also suspend certain losses recognized on the disposition of stock of a subsidiary member.

DATES: This document is effective on March 14, 2003.

FOR FURTHER INFORMATION CONTACT: Aimee K. Meacham, (202) 622-7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final and temporary regulations (T.D. 9048) that are the subject of these corrections are under section 1502 of the Internal Revenue Code.

Need for Correction

As published, the final and temporary regulations (T.D. 9048) contain errors that may prove to be misleading and are in need of clarification. In particular, this document supplies text clarifying § 1.1502-35T(c)(5)(i).

Correction of Publication

Accordingly, the publication of the final and temporary regulations (T.D. 9048) that were the subject of FR. Doc. 03-6119, is corrected as follows:

§ 1.1502-35T [Corrected]

1. On page 12294, column 1, § 1.1502-35T(c)(5)(i), line 8 from the bottom of the paragraph, the language “subsidiary (or any successor) is not a” is corrected to read “subsidiary (and any successor) is not a”.

La Nita Van Dyke,
*Acting Chief, Publications
and Regulations Branch,
Legal Processing Division,
Associate Chief Counsel (Procedure
and Administration).*

(Filed by the Office of the Federal Register on January 12, 2004, 8:45 a.m., and published in the issue of the Federal Register for January 13, 2004, 69 F.R. 1918)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.

ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.

PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2003–27 through 2003–52 is in Internal Revenue Bulletin 2003–52, dated December 29, 2003.

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¹ A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2003–27 through 2003–52 is in Internal Revenue Bulletin 2003–52, dated December 29, 2003.