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New Guidance on Capitalizing Intangibles

Part I: General Principles and the Treatment of Created Intangibles

BY DAVID COOPER
(PRACTICAL US/DOMESTIC TAX STRATEGIES)

This article offers an in-depth look at the new final rules for capitalizing costs incurred in acquiring or creating intangible assets. Part I of the article examines the general principles underlying the new rules. It also examines the treatment of created intangibles, highlighting differences between the final rules and the rules as they were initially proposed.

Overview

The US Treasury Department and the Internal Revenue Service have issued final regulations on capitalizing costs incurred in acquiring or creating intangible assets. The regulations generally follow rules proposed approximately one year ago and become effective upon publication in the Federal

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US Tax Shelter Regulations

Practical Procedures for Complying With the New Rules

BY JOHN LILLIS
(WHITE & CASE, NEW YORK)

This article reviews certain provisions of the federal tax shelter regulations as currently in effect and proposes procedures that may be adopted to comply with those regulations.

Introduction

The Internal Revenue Service issued final regulations on February 28, 2003, which address the reporting, list maintenance, and document retention requirements of §§6011 and 6112 of the Internal Revenue Code. For transactions caught within the scope of the new regulations, the regulations require taxpayers to report to the IRS information, and to retain documents, with respect to such transactions, and require certain advisors in the transactions to comply with list maintenance and document retention procedures.

Over the past several months taxpayers and tax practitioners have been struggling to develop and implement procedures to address the requirements set forth in the new regulations. What is clear is that the regulations contain many ambiguities.

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A fair reading of certain provisions of the regulations lead to the conclusion that the regulations require reporting, list maintenance, and document retention in circumstances that certainly were not intended to be within the scope of the regulations. Commentators have suggested revisions to clarify the requirements. Certain IRS officials have indicated, albeit only orally, a willingness to consider revisions to the regulations to target more precisely the transactions intended to be addressed (*i.e.*, potentially abusive tax-motivated transactions.)

The procedures should be adopted and followed with respect to any matter, transaction, or arrangement engaged in or undertaken by a taxpayer.

This article will summarize briefly certain provisions of the regulations as currently in effect and will propose procedures that may be adopted to comply with the regulations.

Under the regulations, a US taxpayer that "participates" in any one of six categories of transactions is required to disclose this participation to the IRS. The six categories of reportable transactions are as follows: (1) certain IRS-identified listed transactions, (2) confidential transactions, (3) transactions with contractual protection, (4) loss transactions, (5) transactions with a significant book-tax difference and (6) transactions involving a brief asset holding period.

Reportable Transaction Categories

Listed Transactions

A listed transaction is a transaction that is the "same or substantially similar" to any tax avoidance transaction the IRS has identified as a listed transaction in a notice, regulation, or other form of published guidance. As the foregoing would indicate, it is expected that relatively few transactions will constitute listed transactions.

Confidential Transactions

A confidential transaction is any transaction in which a US taxpayer's disclosure of the US federal income tax treatment or tax structure of the transaction is limited in any manner by an express or implied understanding or agreement with, or for the benefit of, any person who makes or provides a statement (oral or written) to the taxpayer as to the poten-

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Planning Advisory

Final Research Credit Regulations Issued
Part I: Defining Key Terms and Setting Requirements

BY DAVID COOPER
(PRACTICAL US/DOMESTIC TAX STRATEGIES)

This article provides an in-depth description and explanation of the latest rules on the federal tax credit for businesses that increase certain research activities. Among other things, the article explains the rather elaborate definition of qualified research for purposes of taking advantage of the credit.

Overview

The US Treasury Department and the Internal Revenue Service have issued final regulations regarding the research credit under §41 of the Internal Revenue Code. Among other things, the regulations provide rules for determining which research activities are eligible for the credit. The federal tax authorities have also issued a new notice requesting additional comments from taxpayers on proposed rules for claiming the credit for internal-use software.

The newly-issued final regulations replace regulations that were issued in January 2001. Shortly after the January 2001 regulations were issued, the tax authorities began reviewing them and sought additional comments from taxpayers.

The final regulations being issued now include significant changes in the provisions implementing the statutory requirement that qualifying research be "undertaken for the purpose of discovering information which is technological in nature." The new regulations also elaborate on the statutory requirement that qualifying research constitute a "process of experimentation."

The authorities have not finalized the research credit rules for "internal-use software" (*i.e.*, software developed by a taxpayer primarily for the taxpayer's internal use). To qualify for the credit, internal-use software must satisfy additional requirements.

The final regulations being issued now include significant changes in the provisions implementing the statutory requirement that qualifying research be "undertaken for the purpose of discovering information which is technological in nature." The new regulations also elaborate on the statutory requirement that qualifying research constitute a "process of experimentation."

Since 1997, the Treasury Department and the IRS have issued a series of proposed and final regulations addressing the definition of internal-use software and the additional qualification requirements for it. The federal tax authorities have now decided that additional public input would be helpful before any internal-use software rules are finalized. Thus, the federal tax authorities are asking for additional comments at this time. Part II of this article, which will appear in next month's issue of *Practical Strategies*, summarizes

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and explains the newly-proposed rules for internal-use software.

In the meantime, taxpayers may rely on either the final regulations issued in January 2001 or proposed regulations issued in December 2001 to claim the research credit for internal-use software. The tax authorities have not yet decided whether final regulations for internal-use software will have any retroactive effect.

Background on the Regs

The final regulations address the definition of qualified research under §41(d) of the Code for purposes of obtaining a federal tax credit for increasing research activities. The regulations are effective upon publication in the Federal Register, which should take place during the first week of January 2004.

In December 1998, the Treasury Department and the IRS published proposed regulations under §41 of the Code concerning the credit for increasing research activities (the "1998 proposed regulations"). Those regulations addressed: (1) the definition of qualified research under §41(d); (2) the application of exclusions from the definition; and (3) the application of a "shrinking-back" rule.

The final regulations discussed in this article generally follow the 2001 proposed regulations. However, the final regulations elaborate on the requirement that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation."

In January 2001, the federal tax authorities published final regulations on the definition of qualified research ("T.D. 8930"). In response to taxpayer concerns about the effects of T.D. 8930, on January 31, 2001, the tax authorities issued Notice 2001-19, announcing that they would review T.D. 8930 and reconsider comments previously submitted in connection with finalizing T.D. 8930. Notice 2001-19 also said that, upon completing this review, the authorities would make any changes to the final regulations in the form of proposed regulations.

In December 2001, the Treasury Department and the IRS issued a new set of proposed regulations, reflecting their review of T.D. 8930 (the "2001 proposed regulations"). After considering comments received and statements made at a public hearing, parts of the 2001 proposed regulations are now being adopted, with certain changes that are summarized and explained below.

The final regulations discussed in this article generally follow the 2001 proposed regulations. However, the final regulations elaborate on the requirement that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation."

Defining the "Process of Experimentation"

The Tax Reform Act of 1986 narrowed the definition of qualified research and changed it by adding a "process of experimentation" requirement. Under §41(d)(1) of the Code, to constitute qualified research, substantially all of the activities of the research must constitute elements of a process of experimentation related to a new or improved function, performance, reliability, or quality. The legislative history to the 1986 Act explained that "[t]he determination of whether research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." H.R. Conf. Rep. No. 99-841, at II-71 (1986).

The legislative history also said that "process of experimentation" means "a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the outset." *Id.*, at II-72. In this regard, the process of experimentation may involve developing one or more hypotheses, testing and analyzing those hypotheses (through modeling or simulation, for example), and refining or discarding the hypotheses as part of a sequential design process to develop the overall component.

The 1998 proposed regulations defined a process of experimentation as "a process to evaluate more than one alternative designed to achieve a result where the means of achieving that result are uncertain at the outset." The 1998 proposed regulations also described it as a four-step process requiring taxpayers to: (1) develop one or more hypotheses designed to achieve the intended result; (2) design a scientific experiment to test and analyze those hypotheses (through modeling, simulation, or a systematic trial and error methodology); (3) conduct the experiment and record the results; and (4) refine or discard the hypotheses as part of a sequential design process to develop or improve the business component.

Most taxpayers that commented on the 1998 proposed regulations objected to the prescribed four-step test, arguing that it was not appropriate for evaluating certain commercial and industrial research activities. In response, the Treasury Department and the IRS said, in T.D. 8930, that taxpayers may engage in the four-step process, but were not required to do so, and therefore eliminated a specific recordation requirement.

T.D. 8930 kept the underlying process of experimentation requirement, however, calling the process of experimentation "a process to evaluate more than one alternative designed to achieve a result where the capability or method of achieving that result is uncertain at the outset."

The 2001 proposed regulations also addressed the definition of a process of experimentation, stating that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities."

The 2001 proposed regulations changed the general requirement to provide, first, that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result," and, secondly, that a process of experimentation may exist if a taxpayer performs research to establish the appropriate design of a business component, even when the capability and method for developing or improving the business component are not uncertain.

The 2001 proposed regulations also said that a taxpayer's activities do not constitute elements of a process of experimentation when the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are "readily discernible and applicable" as of the beginning of the research activities, so that true experimentation in the scientific or laboratory sense would not be undertaken to test, analyze, and choose among alternatives.

Finally, the 2001 regulations emphasized that the determination of whether a taxpayer has engaged in a process of experimentation depended on the facts and circumstances of the research activities and, for this purpose, identified three non-dispositive and non-exclusive factors that indicated a taxpayer has engaged in a process of experimentation.

Taxpayers expressed concern about the process of experimentation requirement in the 2001 regulations, pointing out that the rules and terms used (including "uncertainty," "appropriate design," and "readily discernible and applicable") were not clear. Specifically, taxpayers found the terms "readily discernible and applicable" very subjective and capable of being construed as a variation of the discovery test in T.D. 8930.

The final regulations keep the requirement that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities."

One commentator expressed concern about the meaning and scope of the term "uncertain" and suggested adding examples showing the factors that indicated a taxpayer has engaged in a process of experimentation. Another commentator noted that the 2001 regulations appeared to allow the inclusion of all design costs as qualified research expenditures to the extent that the appropriate design of the desired result is never certain at the outset of the typical design process.

According to the Treasury Department and the IRS, the process of experimentation test requires an evaluation of the facts and circumstances of a taxpayer's research activities. The requirement is not supposed to be inflexible or too narrow. Nevertheless, the federal tax authorities say they continue to believe that the requirement in the 2001 proposed regulations that a process of experimentation is "a process designed to evaluate one or

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more alternatives to achieve a result" implies that research activities must contain certain core elements to constitute a process of experimentation within the meaning of §41(d).

As a result, the final regulations make the following changes to the process of experimentation requirement in the 2001 proposed regulations.

"Core Elements" of the Process of Experimentation Requirement

The final regulations keep the requirement that "a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities." The regulations emphasize that a taxpayer's activities must be directed at resolving uncertainty in the development or improvement of a business component, and that the process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science in attempting to resolve the uncertainty.

According to the tax authorities, these concepts are stated explicitly in the 1986 legislative history and are implicit in the statute, but have not received appropriate weight in previous rules regarding the process of experimentation requirement. Thus, the latest set of final regulations include what the authorities consider to be the "core elements" of a process of experimentation for purposes of qualifying for the research credit.

A taxpayer must identify the uncertainty regarding the development or improvement of a business component that is the object of the research activities. The taxpayer also must identify one or more alternatives to eliminate this uncertainty.

A taxpayer must identify and conduct a process of evaluating alternatives. For example, this process might involve modeling, simulation, or a systematic trial and error methodology.

Additionally, a taxpayer must identify and conduct a process of evaluating alternatives. For example, this process might involve modeling, simulation, or a systematic trial and error methodology.

Further, the process of experimentation "must be an evaluative process and generally should be capable of evaluating more than one alternative." Although the identification and evaluation of more than one alternative is necessary to satisfy the process of experimentation requirement, the Treasury Department and the IRS believe that a taxpayer's activities generally should be capable of evaluating more than one alternative and must be designed to evaluate the alternatives being considered.

Under the final regulations, the mere existence of uncertainty about the development or improvement of a business component does not indicate that all of a taxpayer's activities undertaken to achieve that new or improved component constitute a process of experimentation, even if the taxpayer actually achieves the new or improved business component. The federal tax authorities believe that the separate process of experimentation requirement in the statute makes this point clear.

However, the tax authorities say they have mentioned this point in the final regulations because they believe taxpayers have not been giving sufficient weight to the requirement that a taxpayer engage in a process designed to evaluate alternatives to achieve a result when the capability or the method of achieving that result, or the appropriate design of the result, is uncertain at the beginning of the taxpayer's research activities. This point is supposed to indicate that merely demonstrating that uncertainty has been eliminated (*e.g.*, achieving the appropriate design of a business component when that design was uncertain at the beginning of the research activities) is not sufficient to satisfy the process of experimentation requirement. A taxpayer must demonstrate that its research activities also satisfy the process of experimentation requirement.

All of the facts and circumstances of a taxpayer's research activities are taken into account in determining whether the taxpayer identified uncertainty concerning the development or improvement of a business component, identified one or more alternatives intended to eliminate that uncertainty, and identified and conducted a process of evaluating the alternatives. Although the final regulations describe the core elements of a process of experimentation, how a taxpayer's qualified research activities reflect the core elements will depend on the facts and circumstances.

The core elements will not necessarily occur in a strict, sequential order. A process of experimentation is an evaluative process and therefore often involves refining throughout much of the process the taxpayer's understanding of the uncertainty it is trying to address, changing the alternatives being evaluated to eliminate that uncertainty, or changing the process used to evaluate those alternatives.

Thus, the final regulations do not provide detailed steps on how the regulatory provisions should be applied to a given factual situation. Rather, the Treasury Department and the IRS have concluded that the application of rules will depend on the specific activities being claimed by a taxpayer as qualified research, the nature of the taxpayer's business and industry, and the uncertainties being addressed by the taxpayer's research activities.

In this regard, the federal tax authorities note that additional, industry-specific guidance might be appropriate and request comments from taxpayers on the form that guidance should take.

The final regulations do not include the rule in the 2001 proposed regulations (described above) that a taxpayer's activities do not constitute a process of experimentation when the capability and method of achieving the desired new or improved business component, and the appropriate design of the desired new or improved business component, are readily discernible and applicable at the beginning of the research activities. The tax authorities now believe that this rule is no longer necessary because the activities in these circumstances simply do not constitute a process of experimentation as defined in the final regulations.

The proposed regulations did not have a specific recordkeeping requirement beyond the requirements of §6001 and the regulations under that section. The final regulations have not changed this fact. Thus, the process of experimentation requirement should not impose any recordkeeping requirements on taxpayers beyond the requirements in §6001 and the regulations under that section.

The "Substantially All" Requirement

Under the 2001 proposed regulations (and T.D. 8930), the "substantially all" requirement of §41(d)(1)(C) could be satisfied only if 80 percent or more of the research activities, measured on a cost or other consistently-applied reasonable basis, constituted elements of a process of experimentation for a purpose described in §41(d)(3). This requirement was applied separately to each business component.

All of the facts and circumstances of a taxpayer's research activities are taken into account in determining whether the taxpayer identified uncertainty concerning the development or improvement of a business component, identified one or more alternatives intended to eliminate that uncertainty, and identified and conducted a process of evaluating the alternatives.

The Treasury Department and the IRS sought comments on how to apply the substantially all rule and whether research expenses incurred for nonqualified purposes (*i.e.*, relating to style, taste, cosmetic, or design factors) should be included in the credit computation, assuming that substantially all of the research activities constituted elements of a process of experimentation for a qualified purpose. The federal tax authorities have now decided that the substantially all requirement can be satisfied even if part of a taxpayer's activities is not for a qualified purpose.

Therefore, under the final regulations, the substantially all requirement will be satisfied if 20 percent or less of a taxpayer's research activities do not constitute elements of a process of experimentation for a purpose described in §41(d)(3) (*e.g.*, a new or improved function, performance, or reliability or quality), as long as the remaining activities satisfy the requirements of §41(d)(1)(A) and are not otherwise excluded under §41(d)(4) (*e.g.*, research after commercial production).

Other Issues

Patent Safe Harbor

Under the regulations, as proposed, the issuance of certain patents is considered conclusive evidence that a taxpayer discovered

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information that is technological in nature, which is intended to eliminate uncertainty concerning the development or improvement of a business component. This safe harbor has not been changed in the final regulations. Specifically, it has not been expanded in any way to cover the other requirements for qualified research in §§41(d)(1) and (3).

"Shrinking-Back" Rule

The shrinking-back rule in the regulations has been changed to make it clear that the rule is not supposed to exclude qualified research expenses from the credit, but rather is supposed to ensure that expenses attributable to qualified research activities are eligible for the research credit for purposes of §41(d)(1).

Research after Commercial Production

The regulations include certain exclusions for research after commercial production, the adaptation of existing business components, and the duplication of existing business components. According to the Treasury Department and the IRS, the variety of factual situations to which these exclusions might apply makes it impractical to provide any additional guidance that is meaningful and broadly applicable to taxpayers. The federal tax authorities say that they believe these three specific exclusions do not cover research activities that otherwise satisfy the requirements for qualified research. Beyond that, the tax authorities caution taxpayers to review carefully research activities that might otherwise fall within the exclusions to ensure that only eligible activities are being included in their credit computations.

According to the federal tax authorities, because the final regulations only "clarify" the 2001 proposed regulations, the final regulations apply to tax years ending on or after the date they have been published in the Federal Register (which should be during the first week of January 2004). For tax years ending before that date, the IRS will not challenge return positions that are consistent with the final regulations.

For example, one taxpayer who commented and the proposed regulations expressed concern that language regarding the clinical testing of pharmaceutical products could exclude from credit eligibility clinical trials performed under an arrangement in which the Food and Drug Administration has granted conditional approval for a pharmaceutical product contingent upon the results of additional clinical trials. Another taxpayer expressed concern that the language would exclude otherwise qualifying activities because the research was not required to be approved by the Food and Drug Administration.

According to the tax authorities, the research after commercial production exclusion (as well as the adaptation and duplication exclusions) do not cover research activities, including additional clinical trials, as long as the trials satisfy the requirements for qualified research under §41.

Effective Date

Notice 2001-19 stated that the provisions of T.D. 8930, including any subsequent changes to those provisions, would be effective no earlier than the date when the completion of the Treasury Department and the IRS review of T.D. 8930 was announced. The 2001 proposed regulations provided that final regulations would apply to tax years ending on or after December 26, 2001, the date the proposed regulations were published in the Federal Register.

According to the federal tax authorities, because the final regulations only "clarify" the 2001 proposed regulations, the final regulations apply to tax years ending on or after the date the final regulations have been published in the Federal Register (which should be during the first week of January 2004). For tax years ending before that date, the IRS will not challenge return positions that are consistent with the final regulations.

[Part II of this article, which will appear in next month's issue of Practical Strategies, covers proposals for taking advantage of the research credit in connection with internal-use software.]

Sources: US Treasury Department Release No. JS-1064, December 22, 2003, and Treasury Decision (T.D.) 9104. ❑

David Cooper is the editor of Practical US/Domestic Tax Strategies. If you have any questions about this article, or about any items in Practical Strategies, please contact David at davidrcooper@earthlink.net.

Current Executive Compensation Issues

Tax issues surrounding appropriate executive compensation have been the subject of both a new audit initiative by the Internal Revenue Service and a decision from the Tax Court. We examine those issues here.

New IRS Audit Initiative

The IRS recently announced a new pilot program to examine executive compensation issues as part of the agency's corporate audits.

As of November, 24 companies had been selected for the program. Although the IRS will not specifically inform taxpayers about whether they have been included in the program, it should not be difficult to determine based upon information requests from the agency.

IRS examiners are likely to ask your corporate tax department to assist the examiners in obtaining the IRS Form 1040 of your corporate executives, so that the examiners can review them for consistency with the company's corporate income tax return. The executives' returns will not be audited as part of the program. Instead, the agency will focus on the timing of the corporate employer's deductions and its compliance with IRS reporting and withholding obligations.

Executives of interest to the IRS are corporate officers and, perhaps, another 15 highly-paid individuals, which could include former employees.

The executive compensation audit initiative is specifically targeting the following issues:

1) nonqualified deferred compensation;
2) stock-based compensation, including "SARS," phantom shares, "NSOs," restricted stock, and statutory options;
3) section 162(m) of the Internal Revenue Code (the limit on deductions for remuneration to certain executives of publicly-held companies);
4) sections 280G and 4999 (regarding golden parachute payments);
5) any split-dollar life insurance arrangements;
6) IRS Notice 2003-47 (regarding the sale of options to family limited partnerships);
7) IRS Notice 2003-22 (concerning offshore leasing companies); and
8) any corporate fringe benefits, especially the personal use of corporate aircraft and automobiles, and any relocation benefits.

For some issues, such as the personal use of corporate aircraft by executives and other employees, the rules are quite specific. For example, an executive's personal use of corporate aircraft should be available from flight logs, but the value of the personal use may not be properly reported on the executive's IRS Form W-2, either because the information was not transmitted to corporate payroll administrators, or because the payroll administrators are not familiar with applying the rules.

Executives of interest to the IRS include corporate officers and perhaps another 15 highly-paid individuals, which could include former employees.

For other issues, such as deferred compensation, the rules are less specific. Thus, a careful review of the deferred compensation plan and its operation is necessary to determine compliance. The amounts involved in these issues can be significant and can have Securities and Exchange Commission reporting implications, in addition to federal, state, and local tax consequences.

Tax Court Addresses Executive Comp

In September, the Tax Court held that an acquired corporation was entitled to amortization deductions for payments it made after assuming its new parent's loan commitment fee obligation. *Square D Co. v. Commissioner*, 120 T.C. No. 11 (September 26, 2003). The court also held that lump sum payments negotiated between the new parent and certain retained senior executives were parachute payments. For some of the executives, no portion of the payments was considered reasonable compensation.

The latter point is of particular significance because the Tax Court has not addressed the issue of reasonable compensation for purposes of §280G of the Code in 10 years, and an intervening appellate opinion has raised a question regarding the appropriate test in these circumstances.

With respect to the executive compensation issue, the Tax Court held that certain lump sum

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payments paid to retained executives of the acquired company, pursuant to new agreements with the new parent, were parachute payments except to the extent that any portion constituted reasonable compensation for services to be rendered on or after the change in ownership or control.

A key question was the appropriate test for determining the reasonableness of compensation for purposes of §280G of the Code. The Tax Court concluded that a multi-factor test is appropriate (*e.g.*, looking at the employees' skills and duties, prior earning capacity, and the prevailing compensation paid to employees in comparable jobs).

The Seventh Circuit has applied an "independent investor" test in considering the reasonableness of compensation for purposes of §162(a), but the Tax Court held here that the independent investor test is inappropriate for §280G purposes. The Tax Court reasoned that the two statutes address different problems, that Congress intended a multi-factor test under §280G, and that applying an independent investor test under §280G would result in a finding that the amounts paid were reasonable.

The court rejected the use by the subsidiary's expert witness of an executive's aggregate data over a four-year period, holding instead that reasonableness must be assessed based on data from a single year. The court also rejected the subsidiary's contention that reasonableness may be demonstrated in the aggregate, based on the retained executives as a group.

Source: Deloitte & Touche, Tax News &Views. ❑

Intangibles

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Register (most likely during the first week of January 2004).

Among other things, the final regulations describe specific categories of expenditures incurred in acquiring or creating intangible assets that taxpayers must capitalize. The idea is to clarify how taxpayers should apply §263(a) of the Internal Revenue Code.

The final regulations describe specific categories of expenditures incurred in acquiring or creating intangible assets that taxpayers must capitalize.

Expenditures incurred in acquiring, creating, or enhancing intangible assets that are not described in the final regulations are not required to be capitalized under §263(a) of the Code; however, another provision of the Code might require them to be capitalized.

According to the federal tax authorities, the categories described in the regulations will be construed broadly to counter taxpayers' arguments that a particular intangible created by a taxpayer is not literally described in the categories. The new rules also describe certain types of enhancements to intangible assets that must be capitalized.

The final regulations include safe harbors and simplifying assumptions that allow for the current deduction of certain costs and, presumably, that will reduce taxpayers' compliance burdens. For example, a "12-month rule" allows taxpayers to expense (and not capitalize) amounts paid to create rights or benefits that do not extend beyond a 12-month period. There is also a "*de minimis*" rule for small costs, as well as rules for the treatment of employee compensation and overhead. The new rules also allow a 15-year amortization period for certain created intangible assets that do not have a readily ascertainable useful life.

The regulations include provisions for 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, including the formation or organization of a disregarded entity, an acquisition of capital, a stock issuance, borrowing, and the writing of an option.

Along with issuing the final regulations, the IRS published a notice (Notice 2004-6) informing taxpayers that the tax authorities plan to propose regulations covering the treatment of expenditures to repair, improve, or rehabilitate tangible property. The notice essentially identifies the issues the tax authorities plan to address in the forthcoming proposed regulations and asks for comments on specific rules and principles that should be covered.

The Treasury Department and IRS also plan to address the treatment of costs related to the development and implementation of computer software and costs required to be capitalized in certain transactions, including tax-free acquisitive transactions and stock issuance transactions.

Background on the Regs

In January 2002, the Treasury Department and the IRS announced plans to issue regulations on the extent to which §263(a) of the Code requires taxpayers to capitalize amounts paid to acquire, create, or enhance intangible assets. In December 2002, the federal tax authorities issued proposed rules under §263(a) relating to the capitalization requirement, §167 concerning safe harbor amortization, and §446 on the allocation of debt issuance costs. The tax authorities held a public hearing on the matter and received written comments. Now, the authorities are adopting the proposed rules with the changes described in this article.

At the outset, the basic format of the regulations has changed. The final regulations keep the rules on the capitalization of amounts paid to acquire or create intangibles and amounts paid to facilitate the acquisition or creation of intangibles in §1.263(a)-4. However, rules for the 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 now in new §1.263(a)-5.

By dividing the rules into two regulation sections, the tax authorities said they could apply the "simplifying conventions" to acquisitions of tangible assets in §1.263(a)-5, while limiting the application of §1.263(a)-4 to the costs of acquiring and creating intangibles. The format of §§1.446-5 and 1.167(a)-3 has not been changed significantly.

General Principles

As mentioned above, the final regulations identify categories of intangibles that must be capitalized. Amounts paid to acquire or create intangibles not otherwise required to be capitalized by the regulations need not be capitalized on the ground that they produce significant future benefits for taxpayers, unless the IRS publishes guidance requiring the capitalization of the expenditures. If the IRS publishes this guidance, it will apply prospectively.

The final rules change the general capitalization principles in the proposed rules in three ways. First, §1.263(a)-4 of the final regulations does not include a rule requiring the 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." The rules covering this situation are now in §1.263(a)-5.

Second, the final regulations eliminate the word "enhance" from parts of the general principles. Taxpayers pointed out that the use of the term might require capitalization in unintended circumstances. For example, if a taxpayer has acquired 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 include safe harbors and simplifying assumptions that allow for the current deduction of certain costs and, presumably, will reduce taxpayers' compliance burdens.

Thus, the final regulations have dropped the word "enhance" in favor of more specifically identifying the types of enhancements for which capitalization is appropriate (*e.g.*, an amount paid to upgrade a taxpayer's 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," which was in the proposed regulations. Instead, the final regulations simply identify categories of intangibles for which expenditures must be capitalized.

Keep in mind 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 §162(a) or §212) or relevant regulations. Thus, where another Code section (or regulations under that section) prescribes a specific treatment of an amount, that section will apply and not the rules described here (*e.g.*, the treatment of an insurance company's policy acquisition expenses under §§848 and 197(f)(5) of the Code and the treatment of deductible expenses under §174).

The general definition of a separate and distinct intangible asset in the final regulations remains the same as it was in the proposed regulations, except

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that the final rules add that a separate and distinct intangible asset must be intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions on assignability) separate and apart from a trade or business. The final rules also note that a fund is a separate and distinct intangible asset if amounts in the fund may revert to the taxpayer.

Also, the application of the separate and distinct intangible asset definition to specific intangibles has been limited further in the final regulations. The final rules 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.

The final regulations eliminate the use of the term "intangible asset," which was in the proposed regulations. Instead, the final regulations simply identify categories of intangibles for which expenditures must be capitalized.

Finally, the final regulations include new examples intended to show that product launch costs and stock-lifting costs do not create a separate and distinct intangible asset.

Clear Reflection of Income

What is the interaction between the capitalization rules being adopted now and the 'clear reflection of income' standard in §446(b) of the Code? Taxpayers asked whether the IRS would take the position that an expenditure that was not required to be capitalized by the new regulations should still be capitalized because deducting the expenditure would not clearly reflect income under §446.

According to the Treasury Department and the IRS, if an amount paid to acquire or create an intangible is not required to be capitalized by another provision of the Code or regulations, or by the final regulations described here, or in subsequent published guidance, the IRS will not take the position that the clear reflection of income standard in §446(b) requires capitalization.

Acquired Intangibles

Under the final regulations (as under the proposed regulations) a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. The regulations provide a nonexclusive list of intangibles for which capitalization is required. To emphasize that this list is merely illustrative, and not definitive, the final rules change the introductory language to state specifically that the list contains only "examples" of intangibles.

Created Intangibles

As mentioned above, the final regulations keep the eight categories of created intangibles that were identified in the proposed regulations. However, the final regulations eliminate the term "enhance" from the general principle of capitalizing intangibles and, instead, more specifically identify the types of enhancements for which capitalization must be done.

The final regulations also state that the determination of whether an amount is paid to create an intangible is made based on all of the facts and circumstances, disregarding distinctions between the labels used in the regulations to describe the intangible and labels used by the taxpayer and other parties to describe the transaction. As mentioned above, the Treasury Department and the IRS plan to construe broadly the categories of intangibles identified in the regulations in response to any narrow technical arguments that an intangible created by a 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 by arguing that the right is an "admission" or that it explicitly gives the taxpayer a "participation right," but not a membership.

Financial Interests

Taxpayers must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate with that party certain financial interests. Those financial interests include, for example: (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, regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes; and (c) a financial instrument, such as a letter of credit, credit card agreement, notional principal contract, foreign currency contract, futures contract, forward contract, option, or any other financial derivative.

In essence, the final regulations have kept the categories of financial interests that were identified in the proposed regulations, with only a few changes.

For example, the final regulations do not include the rule from 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 before the end of the tax year in which the amount is paid. According to the tax authorities, the rule was unnecessary and was incorrectly interpreted to suggest that you could immediately deduct amounts paid to create or originate an option or forward contract.

Prepaid Expenses

The final regulations have kept the rule for capitalizing prepaid expenses, which was set forth in the proposed regulations. However, a reference to "benefits to be received in the future" has been dropped to avoid any suggestion that a "significant future benefits" test should be applied.

For example, consider a cash method taxpayer that decides to enter into a 24-month lease of office space. Upon signing the lease, the taxpayer prepays $240,000, and no other amounts are due under the lease.

Per the capitalization rules, the $240,000 is treated as a prepaid expense, which the taxpayer must capitalize.

Memberships and Privileges

The final regulations have also kept the rule for memberships and privileges, which was set forth in the proposed regulations, but add that capitalization is also required if a taxpayer renegotiates or upgrades a membership or privilege. Basically, the rule now is that you must capitalize amounts you have paid to an organization to obtain, renew, renegotiate, or upgrade a membership or privilege from that organization. You do not need to capitalize amounts paid to obtain, renew, renegotiate, or upgrade a certification of your products, services, or business processes, however.

Rights Obtained From a Governmental Agency

The final regulations have kept the rule for rights obtained from a government agency, again adding that capitalization is also 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.

The rule for capitalizing certain rights obtained from a government agency is that you must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade your rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

Note that an amount paid to obtain a patent from a government agency need not be capitalized when §174 of the Code applies to the same amount (*i.e.*, when the amount can be deducted under that section). This is an example of a situation in which the new capitalization rules will not affect the treatment of an expenditure under other provisions of the Code.

Contract Rights

The final regulations have also kept the capitalization rules for certain contract rights, as set forth in the proposed regulations. These are amounts paid to enter into certain agreements, including, for example, an agreement giving you the right to use tangible or intangible property, or the right to be compensated for the use of tangible or intangible property; an agreement giving you the right to provide or receive services (or the right to be compensated for the services regardless of whether you actually provided them); and a covenant not to compete or similar agreement.

Taxpayers must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate with that party certain financial interests.

The final rules add that you must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate with that party a "standstill agreement" (*i.e.*, an agreement not to acquire additional ownership interests in the taxpayer).

According to the federal tax authorities, the benefits obtained by a taxpayer from a standstill agreement are similar to the benefits from other agreements concerning contract rights and that capitalization is therefore appropriate. However, the new capitalization rule does not apply to a standstill agreement governed by another provision of the Code (*e.g.*, §162(k)).

The final rules also state that you 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 property and casualty policy) if the taxpayer is the covered party under the contract.

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Further, the final regulations add three rules to address the concern that capitalization might not be appropriate if a taxpayer has only a hope or expectation that a customer or supplier will begin or continue a business relationship with the taxpayer.

First, amounts paid with the mere hope or expectation of developing or maintaining a business relationship do not need to be capitalized if the amount is not contingent on the origination, renewal, or renegotiation of an agreement. The tax authorities believe that these contingent amounts are properly capitalized as amounts paid to originate, renew, or renegotiate the agreement.

Second, an agreement does not provide a "right" to provide services if it merely provides that the taxpayer will stand ready to provide them if requested, but places no obligation on anyone to request or pay for the taxpayer's services.

The final regulations have kept the rule for rights obtained from a government agency, again adding that capitalization is also 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.

Third, an agreement that can be terminated at will by the other party (or parties) before the expiration of the period prescribed by the "12-month rule" (see below) is not an agreement providing the taxpayer with the right to use property or provide (or receive) services. However, if the other party (or parties) to the agreement is economically compelled not to terminate the agreement before the expiration of the 12-month rule, then the agreement is not one that may be terminated at will. Examples have been added to the final regulations to illustrate these new rules.

The final regulations also address the meaning of the term "renegotiate." Here, a taxpayer is treated as renegotiating an agreement if the terms of the agreement are changed. Further, 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.

The final regulations have also kept the $5,000 *de minimis* rule that was in the proposed regulations and specify 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. There is also a safe harbor pooling method for the *de minimis* costs of creating similar agreements.

Contract Terminations

The final regulations have kept the rule regarding contract terminations, which was in the proposed regulations. Basically, the rule is that you must capitalize amounts paid to another party to terminate: (a) a lease of real or tangible personal property between you (as the lessor) and the lessee; (b) an agreement granting someone the exclusive right to acquire or use your property or services, or to conduct your business; or (c) an agreement prohibiting you from competing with someone or from acquiring property or services from a competitor of that party.

The new contract termination rules do not apply to amounts paid to terminate a transaction subject to §1.263(a)-5 of the regulations (*i.e.*, concerning an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions). *See* Part II of this article, which will appear in next month's issue of *Practical Strategies*, for a discussion of the treatment of amounts paid to terminate these transactions.

Benefits from Real Property

With respect to benefits from the provision, production, or improvement of real estate, the capitalization rule is as follows. You must capitalize amounts paid for real property if you transfer ownership of the property to another person (except to the extent the property is sold for fair market value) and if the property can reasonably be expected to produce significant economic benefits to you after the transfer. You also must capitalize amounts paid to produce or improve real property owned by another (except to the extent that you are selling services at fair market value to produce or improve the real property) if the property can reasonably be expected to produce significant economic benefits for you.

You do not have to capitalize an amount under this rule if you transfer real property or pay 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.

This is the same rule that was set forth in the proposed regulations. The exceptions to this rule apply only to the extent that you receive fair market value consideration for the real property.

Defending or Perfecting Title to Intangible Property

Again, the final regulations have kept the rule for capitalizing expenses related to defending or perfecting title to intangible property, as it was set forth in the proposed regulations. The rule is that you must capitalize amounts paid to another party to defend or perfect title to intangible property if the other party challenges your title to the property.

However, amounts paid to another party to terminate an agreement permitting that party to buy your intangible property or to terminate a transaction described in §1.263(a)-5 of the regulations (*i.e.*, concerning the acquisition of a trade or business, change in capital structure of a business entity, and certain other transactions) are not treated as amounts paid to defend or perfect title.

Transaction Costs

Finally, under the new regulations, you must capitalize amounts that facilitate the acquisition or creation of an intangible. An amount facilitates a transaction if it is paid "in the process of pursuing the transaction." This includes amounts paid to investigate the acquisition or creation of an intangible.

To emphasize 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." The final rules note 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.

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 it is not the only factor to be considered, according to the federal tax authorities. The final regulations have been changed slightly to reflect this position, stating that the fact that the amount would (or would not) have been paid "but for" the transaction is a relevant, but not "determinative" factor.

The final regulations have eliminated the rule in the proposed regulations which treated 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 Treasury Department and the IRS decided that some taxpayers could avoid the rule by using general representations, while others might inadvertently be caught by it. The authorities opted not to impose a "mutually exclusive rule," however, believing that it could be interpreted as requiring the capitalization of contract termination costs that historically have been deductible (*e.g.*, amounts paid to terminate a burdensome supply contract when you enter into a new supply contract with another party). Instead, the final rule now states that an amount paid to terminate (or facilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement.

Under the new regulations, you must capitalize amounts that facilitate the acquisition or creation of an intangible. An amount facilitates a transaction if it is paid "in the process of pursuing the transaction." This includes amounts paid to investigate the acquisition or creation of an intangible.

Note that the final regulations include a new 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 it. This rule is illustrated with an example in the final regulations.

[We will continue our summary and explanation of the new rules for capitalizing intangibles in the next issue of Practical US/Domestic Tax Strategies.]

Sources: US Treasury Department Release No. JS-1062 and Treasury Decision (T.D.) 9107, December 31, 2003. ❑

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Two New Decisions from the Sixth Circuit Affect US Businesses

The US Court of Appeals for the Sixth Circuit recently decided two cases with potentially significant consequences for US businesses. The decisions and their consequences are summarized here.

Uncollectible Receivables

In *Hospital Corp. of America v. Commissioner*, No. 28588-91 (6th Cir., October 30, 2003), the Sixth Circuit held that an affiliated group of companies, which primarily owned, operated, and managed hospitals, had to use the formula in §1.448-2T of the federal income tax regulations to calculate the amount of uncollectible receivables that could be excluded from the group's income. The court also held that subsidiaries that still operated hospitals after spinning off other hospitals had to take into account in one year "§481 adjustments" remaining from a prior year.

Accrual method taxpayers that use the non-accrual experience method for bad accounts compute the estimated uncollectible receivables by multiplying the year-end receivables for the current year by a ratio of average bad debts written off during the current year and the previous five years, divided by average total sales for the same period.

Some HCA subsidiaries changed to the accrual method of accounting in 1987 and began taking into account positive adjustments under §481(a) of the Internal Revenue Code. Those HCA companies that were not operating hospitals spread the adjustment over four years, while the companies that were operating hospitals spread the adjustment over 10 years. Later, through a series of transactions, some HCA subsidiaries became new parent companies to new subsidiaries, whose stock was sold to a third party. The new parent companies continued to take a 10-year adjustment with respect to the hospitals that had been spun off.

The Sixth Circuit addressed two issues: (1) how HCA should calculate the amount to exclude from income because part of the accounts receivable would not be collected; and (2) whether the HCA subsidiaries that still operated hospitals could still get the statutory benefit available for the hospitals that had been spun off.

With regard to excluding income because of uncollectibles, the Sixth Circuit affirmed the Tax Court and held that HCA must use the formula in §1.448-2T of the regulations, citing legal authority for the principle that an federal agency's interpretation is entitled to deference. Under the regulatory formula, accrual method taxpayers that use the non-accrual experience method for bad accounts compute the estimated uncollectible receivables by multiplying the year-end receivables for the current year by a ratio of average bad debts written off during the current year and the previous five years, divided by average total sales for the same period.

The Sixth Circuit also affirmed the Tax Court's ruling that the entire remaining §481 adjustment had to be taken into account in one year. HCA had argued that the regulation's "cessation of business" provision requiring that the adjustment be taken into account in one year is contrary to §448(d)(7), which provides that, for hospitals, the change is taken into account over 10 years.

Although the appellate court agreed that there was some ambiguity regarding how to apply the two provisions, it nevertheless found the IRS interpretation reasonable in the absence of a clear indication of legislative intent in situations involving the cessation of business.

ITC Recapture

In the second case, *Aeroquip-Vickers Inc. v. Commissioner*, No. 01-2741 (Oct. 20, 2003), a divided Sixth Circuit panel held that a consolidated group had to recapture investment tax credits ("ITCs") claimed on §38 property that the group parent transferred to a subsidiary, whose stock was immediately spun out. The decision reversed the Tax Court, but put the Sixth Circuit in line with decisions from other federal appeals courts.

In this case, the Sixth Circuit concluded that two allegedly separate transactions, each undertaken with a valid business purpose, should be treated as steps in a single transaction undertaken for the purpose of avoiding recapture liability.

The taxpayer (previously called "LOF") had a glass manufacturing division that it planned to transfer to a subsidiary. Before any action was taken, one of LOF's shareholders ("Pilkington") approached LOF about acquiring the glass business. In 1986, LOF created a subsidiary, "LOF Glass," and transferred to it all of the assets of the glass division, including the §38 assets on which LOF had previously claimed ITCs. LOF then transferred all of its shares of LOF Glass to a Pilkington subsidiary ("PH") in return for all of the shares of LOF held by PH.

LOF recognized no gain or loss on the transfer of the glass business to LOF Glass, and neither LOF nor PH recognized any gain or loss on the exchange of LOF Glass shares for the LOF shares. On its 1986 consolidated return, LOF did not include any amount of ITC recapture with respect to the §38 assets. The IRS asserted a $5.7 million recapture liability, but the Tax Court rejected that determination.

The Tax Court relied on an example in §1.1502-3(f)(3) of the regulations, in which a transfer of §38 property to a subsidiary and sale of stock to a third party in a subsequent year did not trigger ITC recapture. The court acknowledged that the transfer of the §38 assets from LOF Glass to PH (outside the group) would have triggered recapture liability, but found that LOF transferred the *stock* of LOF Glass (not the assets) to PH. The Tax Court refused to defer to Rev. Rul. 82-20 (in which the IRS focused on the parties' intent at the time of the transfer of the §38 property), finding the revenue ruling in conflict with the regulation.

The Sixth Circuit concluded that Rev. Rul. 82-20 was entitled to substantial deference because it is reasonable and reflects the IRS' "longstanding interpretation of its own regulations."

The appellate court noted that it has previously applied an "end result" test, which focuses on the parties' intent in determining whether the steps of a transaction should be treated separately or as a unit. Applying that test here, the court held that the steps of the transaction had to be "treated as a single unit and judged by its end result." The court agreed with the IRS that the intended end result was to move the property outside the group and avoid recapture liability.

Deloitte & Touche tax professionals have pointed out that one potentially troubling aspect of this decision is the court's acceptance of the fact that each step of the transaction had a "valid business purpose." The taxpayer had argued that it was inappropriate to collapse the multiple steps into a single transaction under the "step transaction" doctrine.

The appeals court stated that the business purpose requirements are not mutually exclusive of the step transaction doctrine, noting a Tenth Circuit decision concluding that the existence of a valid business purpose does not preclude application of the step transaction doctrine.

One potentially troubling aspect of the decision is the court's acceptance of the fact that each step of the transaction had a valid business purpose. The taxpayer had argued that it was inappropriate to collapse the multiple steps into a single transaction under the step transaction doctrine.

The Sixth Circuit majority added that the "substance over form" doctrine is broader than the step transaction doctrine. The court essentially concluded that, regardless of LOF's initial intent to transfer the §38 property within the group, LOF changed its plans so that the substance and end result of the transaction was to transfer the property outside the group.

In reality, it was not necessary for the court to accept that each step had a valid business purpose. According to the Deloitte & Touche tax professionals, the court's legal conclusion suggests that the transfer of the §38 property to LOF Glass *would have had* a business purpose because the transaction was originally planned, but that it lost this business purpose when LOF agreed to transfer the business to its shareholder before any transfer of assets to the subsidiary had occurred.

Source: Deloitte & Touche's Tax News & Views. ❑

Hedge Fund Compensation Arrangements

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This article examines the tax treatment of hedge fund compensation arrangements, pointing out key audit issues that taxpayers need to consider in their planning strategies.

The compensation of hedge fund management is an area of tax planning that needs careful handling. Based on recently released IRS regulatory guidance (described below), the principal audit issues that are likely to arise in the near term concern: (1) IRS reclassification of special allocations of hedge fund income as the payment of hedge fund administrative expenses; and (2) IRS reclassification of the grant of an equity interest (*e.g.*, the grant of a capital or profits interest in a hedge fund) as the receipt of taxable services income.

This article presents an overview of hedge fund compensation arrangements and focuses on these tax planning concerns.

The IRS Audit Guide presents an adversarial and unprecedented approach to hedge fund incentive compensation arrangements.

Primer on Hedge Funds

Although financial service providers, regulators, and the media commonly refer to "hedge funds," the term has no precise legal or universally accepted definition. The term generally identifies an entity that holds a pool of securities and perhaps other assets, that does not register its securities offerings under the Securities Act of 1933, and that is not registered as an investment company under the Investment Company Act of 1940. Hedge funds are also often referred to as "private investment partnerships."

A hedge fund is typically sponsored, organized, and managed by its investment adviser (*e.g.*, a money manager). A hedge fund's investment adviser usually is responsible for establishing the hedge fund and overseeing preparation of the hedge fund's private placement memorandum (also referred to as the "confidential private placement offering memorandum" or, simply, the "OM") and subscription agreement, as well as the applicable limited liability company (or limited partnership) agreement.

Hedge funds can take various forms. They are generally organized as either limited liability companies or limited partnerships. If a hedge fund is a limited liability company, the investment adviser typically serves as the fund's member manager. If the hedge fund is a limited partnership, the investment adviser typically serves as the fund's general partner.

To limit legal liability (while preserving the tax pass-through from the hedge fund without imposing an extra layer of tax), the investment adviser typically establishes either an S corporation or a second limited liability company to function as the member manager (or general partner) of the hedge fund entity.

A secondary advantage of using a separate entity to function as the investment adviser to the hedge fund is that it allows the hedge fund sponsor to give away equity interests in the management entity (*e.g.*, the investment adviser) to help retain, motivate, and compensate key personnel.

Virtually all domestic private hedge funds seek to be classified for federal tax purposes as partnerships rather than as associations taxable as corporations. When a hedge fund is classified as a partnership, its partners (*e.g.*, the investors) are taxed on their respective distributive shares of the hedge fund's items of income, expense, gain, and loss, and the character (ordinary versus capital) of the partnership items pass through to the hedge fund's partners.

Compensation of Investment Advisers

An investment adviser to a hedge fund typically receives an investment management fee and a separate amount referred to as "incentive compensation." This incentive compensation may be described in the OM as either a "performance fee" or a "performance allocation." In either case, the incentive compensation is linked to the hedge fund's investment performance.

Management Fees

The management fee is an asset-based compensation mechanism designed to provide the investment adviser with current cash flow to maintain management company operations. The management fee generally is set at one to two percent of a fund's net asset value.

Incentive Compensation

As stated above, the incentive compensation paid to hedge fund management generally is described in the OM as either a performance fee or a performance allocation. When incentive compensation takes the form of a performance fee, it is an item of expense that is paid by the hedge fund.

Unlike the management fee, the performance allocation represents a special allocation of the partnership that is usually calculated as a percentage (typically 20 percent) of the hedge fund's net investment income, realized capital gains, and unrealized capital appreciation.

A performance allocation can be treated as a special allocation of hedge fund income only when the investment adviser is (or is intended to become) a partner (*e.g.*, an investor) in the hedge fund. When the incentive payment is structured as a special allocation, the items reallocated to the hedge fund's manager retain their character as interest, dividends, and capital gain.

A properly drafted performance allocation provision should not result in tax treatment as a hedge fund item of expense (*e.g.*, a performance fee). It is intended to be characterized as a special allocation of hedge fund income to the investment advisor's capital account of profits that would otherwise be allocated to investor partners' capital accounts.

IRS Audit Stance

Per the IRS Market Segment Specialization Program Audit Technique Guide-Partnerships (December 2002) (the "IRS Audit Guide"), it can be expected that the IRS may take a *per se* audit position (despite the wording of the OM) that performance allocations of hedge fund income to investment advisers are not special allocations of partnership income, but, in fact, are payments of performance-based fees (and therefore hedge fund expense items).

The IRS Audit Guide presents an adversarial and unprecedented approach to hedge fund incentive compensation arrangements.

The general rule is that tax on a partner's entrepreneurial share of partnership profits should be imposed under the framework of the partnership tax rules when the partnership realizes actual profits that are included in a partner's distributive share. Performance allocations are paid from partnership profits. An OM typically contains provisions that protect investors from paying special allocations for poor fund performance, such as "high water marks" and "hurdle rates."

High water marks are thresholds that the investment adviser must achieve before receipt of a special allocation of partnership income. Generally, a high water mark varies for each investor and is based on the maximum value of the investor's interest in the partnership since its initial investment in the fund. The investment adviser must generate investment returns beyond the high water mark before the investment adviser can expect payment of a performance allocation.

In essence, the hedge fund's performance must surpass its previous high point before additional incentive allocations can be distributed.

Hurdle rates are also used to guarantee that the hedge fund achieves a minimum economic performance before the hedge fund's investment adviser may expect payment of a performance allocation. A hurdle rate establishes a performance floor that the investment adviser must exceed to obtain a distribution of the performance allocation.

To avoid the audit risk, some tax advisers to the hedge fund industry continue to recommend that three entities should be used to organize and structure a hedge fund.

Drafting for Tax Results

As noted above, when the incentive compensation arrangement is structured as a special allocation tied to the hedge fund's performance, the items reallocated as a performance to the investment manager retain their character, including long-term capital and unrealized gains.

The IRS Audit Guide ignores the fact that some OMs intentionally present the incentive compensation arrangement as a performance-based fee that results in a hedge fund expense rather than a special allocation of partnership income. This may be the case when a hedge fund's income consists of mostly short-term capital gain from a trader (as opposed to investment-type) hedge fund.

Deferred Incentive Compensation

In addition, when the incentive compensation arrangement is structured as a performance-based fee (rather than a special allocation), the investment advisor may elect, prior to the beginning of each fiscal year, to defer for up to 10 years payment of all or any portion of the management fee or performance fee earned with respect to that subsequent fiscal year. If so, the deferred amount will remain in the hedge fund's account with the in-

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vestment advisor and will appreciate or depreciate based on the fund's subsequent performance.

Any appreciation will be expensed as additional fees and any depreciation will be treated as a reduction of fees. The deferred fees will be reflected on the hedge fund's books as a liability and will reduce the fund's net asset value. Upon expiration of the deferral period, dissolution of the fund, or termination of the investment advisor agreement by the fund, all deferred performance (and management) fees are payable. Upon the termination of the investment advisor agreement, fees elected to be deferred will remain in the hedge fund until the earlier of the end of the deferral period or the dissolution of the fund.

It is not certain that the use of a three-entity structure to organize a hedge fund will preclude or trump an IRS review of the fund's compensation arrangements.

Planning Caveat

To avoid the IRS audit risk described above, some tax advisers to the hedge fund industry continue to recommend that three entities should be used to organize and structure a hedge fund. The structure advocated by the tax advisers requires a limited partnership to function as the hedge fund company; a second entity (such as another limited partnership) to function as the general partner to hedge fund; and a third entity (*e.g.*, either an S corporation or a limited liability company electing to be taxed as a pass-through entity) to serve as the management company of the hedge fund.

Presumably when this structure is used, the OM clearly states that the management company is paid the management fee and the entity functioning as the general partner receives the special performance allocation of hedge fund income. The avowed purpose of this structure is to make it clear to the IRS that the entity serving as the general partner is a true economic partner. The planning expectation is that any payments directed toward the general partner and reported on Schedule K-1 will not be reclassified by the IRS as a hedge fund expense since another entity in the mix functions as a *per se* management company and receives payments in that capacity.

It is not certain that the use of a three-entity structure to organize a hedge fund will preclude or trump an IRS review of the hedge fund compensation arrangements. In fact, the IRS Audit Guide, at Exhibit 12-1, prominently features the use of a three-entity hedge fund structure and concludes that all compensation directed toward hedge fund management is an administrative expense of the fund and that no portion represents a special allocation of hedge fund income.

The IRS Audit Guide (at Page 12-5) expressly states that in all cases the "managing partner is performing personal services, although the income received may be characterized as interest, dividends, and capital gains."

There is no certainty that use of a three-entity hedge fund structure will preclude IRS reclassification of hedge fund performance allocations as administrative expenses. Basically, the IRS plans to take the approach on audit that all compensation paid to the investment manager (whether designated in the OM as a management fee or a performance allocation) constitutes a hedge fund administrative expense.

In other words, the IRS will argue that the payment of a performance allocation to an investment adviser is a hedge fund administrative expense even when payments are bifurcated and paid to two separate entities (as described above).

Profits Interests

The IRS Audit Guide overlooks the fact that the grant of a profits interest to a service provider (such as an investment adviser) is an IRS-sanctioned tax outcome that can be achieved through careful planning and drafting of the OM. One of the most common events involving partnerships is the issuance of a partnership interest to a person in connection with the performance of future (or past) services. However, this is one of the most unsettled areas in the sphere of partnership tax matters.

When the investment adviser is not an actual partner (*e.g.*, an initial investor in the hedge fund), it should be possible to argue that performance allocations are true special allocations representing a compensatory grant of a profits interest for services rendered to the partnership.

The IRS created an administrative safe harbor regarding the tax treatment of compensatory grants of profits interests in Rev. Proc. 93-27, 1993-2 C.B. 343. Under that revenue procedure, the grant of a profits interest that falls within its safe harbor is not a taxable event for either the service provider or the partnership. It defines a profits interest as a partnership interest that is not a capital interest. In other words, the holder of a profits interest would not receive a share of the proceeds upon the hypothetical liquidation of the partnership.

A number of conditions must be met for Rev. Proc. 93-27 to apply. The investment adviser must receive the interest as a partner, or in anticipation of becoming a partner, in exchange for services to the partnership. Moreover, the profits interest cannot relate to a substantially certain and predictable stream of income (such as a high-quality net lease or high-grade debt). Additionally, the investment adviser cannot "dispose" of the interest within two years and the interest cannot be an interest in a publicly-traded partnership.

A profits interest that qualifies under Rev. Proc. 93-27 is a very tax-efficient vehicle for granting equity compensation to an investment provider and insuring that performance allocations are respected as such by the IRS. The OM should reflect the economic arrangements intended by the hedge fund's sponsor.

The compensation of hedge fund management is an area of tax planning that requires careful handling in light of the IRS' proposed audit stance regarding performance allocations paid to hedge fund management. ❑

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Tax Shelters

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tial US federal income tax consequences that may result from the transaction, whether or not the understanding or agreement is legally binding.

A transaction also will be treated as a confidential transaction if the taxpayer knows or has reason to know that the taxpayer's use or disclosure of information relating to the US federal income tax treatment or tax structure of the transaction is limited in any other manner (*e.g.*, where the transaction is claimed to be proprietary or exclusive) for the benefit of any person (other than the taxpayer) who makes or provides a statement, oral or written, to the taxpayer as to the potential US tax consequences that may result from the transaction.

Based on this definition, many ordinary transactions with documentation that contains confidentiality provisions (including, but not limited to, commitment letters, credit agreements, nondisclosure agreements, confidentiality agreements, and purchase or acquisition agreements) will be confidential transactions required to be reported to the IRS unless affirmative steps are taken (as described below) to authorize specifically the disclosure of certain aspects of the transaction.

Transactions with Contractual Protection

A transaction with contractual protection is any transaction for which the taxpayer or a related party has the right to a full or partial refund of fees if all or part of the intended US tax consequences from the transaction are not sustained, or a transaction for which fees are contingent on the taxpayer's realization of US tax benefits from the transaction. For purposes of this rule, "fees" are defined as fees paid by, or on behalf of, the taxpayer or a related party to any person who makes or provides a statement, oral or written, to the taxpayer or related party as to the potential US federal income tax consequences of a transaction.

It is necessary to determine whether any person or entity will reflect a tax benefit on a US return as a result of the arrangement or transaction.

Loss Transactions

A loss transaction is any transaction resulting in a taxpayer claiming a loss for US federal income tax purposes that exceeds certain monetary thresholds for a single taxable year or a combination of taxable years. In general, in the case of corporations, disclosure is required if the transaction results in a loss of $10 million in any single taxable year or $20 million in any combination of taxable years.

For purposes of this rule, losses do not include interest expense, taxes, trade or business expenses, or depreciation deductions. In addition, the IRS has released a revenue procedure (Rev. Proc. 2003-24, 2003-11 I.R.B. 1) that enumerates other significant exceptions from this category, which are tied to true economic losses.

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Transactions with a Significant Book-Tax Difference

A transaction with a significant book-tax difference generally is any transaction resulting in a book-tax difference of more than $10 million for a reporting company under the Securities and Exchange Act of 1934 (or a related entity), or for a business entity with at least $250 million in gross assets for book purposes (subject to aggregation with respect to assets of related entities). The IRS has released a revenue procedure (Rev. Proc. 2003-25, 2003-11 I.R.B. 1) that enumerates many significant exceptions from this category.

Transactions Involving a Brief Asset Holding Period

A transaction involving a brief asset holding period is any transaction resulting in the taxpayer claiming a tax credit for US tax purposes exceeding $250,000 (including a foreign tax credit) if the underlying asset giving rise to the credit is held by the taxpayer for less than 45 days.

The definition of "participation" varies depending on the category of reportable transaction, but generally turns on whether the taxpayer's income tax or information return reflects a tax benefit or consequence of the transaction.

Consequences of Participation in a Reportable Transaction

If a taxpayer participates in one of the above-listed reportable transactions, the taxpayer must:

- attach an IRS Form 8886 (*Reportable Transaction Disclosure Statement*) to its US federal income tax or information return for each taxable year in which the taxpayer participates (as described below) in the reportable transaction;
- send a copy of the Form 8886 to the IRS Office of Tax Shelter Analysis at the same time that the Form 8886 is first filed with the taxpayer's US income tax or information return; and
- retain a copy of all documents and other records (generally, final versions or most recent drafts) related to the transaction that are material to an understanding of the US federal income tax treatment or tax structure of the transaction. These documents and records must be retained until the expiration of the statute of limitations applicable to the final taxable year for which disclosure was required.

The definition of "participation" varies depending on the category of reportable transaction, but generally turns on whether the taxpayer's US income tax or information return reflects a tax benefit or a tax consequence of the transaction. In the case of confidential transactions, the taxpayer has participated in a confidential transaction if the taxpayer's US income tax or information return reflects a tax benefit (which may include any tax deductions from a transaction taken on a return) from the transaction and the taxpayer's disclosure of the tax treatment or tax structure of the transaction is limited as described in the section on confidential transactions above.

Generally, if a partnership, S corporation, or trust's disclosure is limited, but the partner, shareholder, or beneficiary's disclosure is not limited, then the entity, but not the partner, shareholder, or beneficiary, has participated in the confidential transaction and must report.

In addition, related list-maintenance rules require that, with respect to a reportable transaction, a "material advisor" to a taxpayer (including a law firm, an arranger, or other advisor to, or promoter of, a transaction) must prepare and maintain a list of each person to whom the material advisor makes or provides a statement, oral or written, that relates to a US tax aspect of a transaction, as well as certain other related information. The material advisor must retain the list for seven years following the earlier of the date on which the material advisor last made a tax statement with respect to such US tax consequences or the date the transaction was entered into. The material advisor must provide the list to the IRS upon written request, subject to claims of attorney-client privilege. The material advisor also must retain relevant documentation relating to the transaction.

In general, a "material advisor" is defined as any person who either: (a) is required to register the transaction under the tax shelter reporting rules of §6111 of the Code; or (b) (1) receives or expects to receive in connection with a transaction a minimum fee that exceeds a threshold amount, and (2) makes a statement, oral or written, that relates to a US tax aspect of the transaction and the statement is made to, or for the benefit of, among other persons, a taxpayer that is required to disclose the reportable transaction.

Preventing Classification of a Transaction as "Confidential"

Under a safe harbor in the regulations, a transaction is presumed not to be offered under conditions of confidentiality if certain language is included in the related documentation that expressly authorizes the taxpayer to disclose the US tax treatment and tax structure of the transaction. The regulations provide that a transaction is not considered to be confidential if every person who makes or provides a statement, written or oral, to the taxpayer as to the potential US tax consequences that may result from the transaction, provides the following express written authorization in substantially the following form to the taxpayer:

> The taxpayer (and each employee, representative, or other agent of the taxpayer) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the transaction and all materials of any kind (including opinions or other tax analyses) that are provided to the taxpayer relating to such tax treatment and tax structure.

The presumption is only available if the authorization is effective immediately upon commencement of discussions relating to the transaction and will not be available if it is simply inserted into the final documentation. As such, it is important to incorporate the language into commitment letters, term sheets, and other initial transaction documentation from the outset of a transaction.

A transaction will not be considered to be confidential if disclosure of the US federal income tax treatment or tax structure of the transaction is subject to restrictions reasonably necessary to comply with securities law and the disclosure is not otherwise limited.

In addition, in the case of a taxable or tax-free acquisition of: (i) the historic assets of a corporation that constitute an active trade or business that the acquirer intends to continue; or (ii) more than 50 percent of the stock of a corporation that owns historic assets used in an active trade or business that the acquirer intends to continue, the transaction generally is not considered confidential if the taxpayer is permitted to disclose the US federal income tax treatment and tax structure of the transaction no later than the earliest of: (1) the date of the public announcement of discussions relating to the transaction, (2) the date of the public announcement of the transaction, or (3) the date of the execution of an agreement (with or without conditions) to enter into the transaction.

Procedures to Be Adopted

To demonstrate that reasonable efforts have been taken to comply with the requirements of the regulations, the following procedures may prove to be effective. The focus of these procedures is on the category of reportable transactions that come under the heading "confidential transactions."

Clearly, confidential transactions are the broadest scope of transactions caught within the parameters of the regulations. If your transaction may be in one of the other five categories of transactions outlined above, you should contact a US tax advisor to determine the appropriate steps that should be taken to comply with the requirements of the regulations.

The goal of these procedures is to have practical application. That is, the goal is to provide procedures that can be applied by non-tax practitioners. Thus, these procedures employ non-technical terms that err on the side of greater disclosure and compliance.

It should be noted as a caution, however, that a rigid interpretation of the regulations will require an understanding of many technical terms, including "participant," "tax treatment," "tax structure," "tax benefit," and "transaction," among many others. The meanings of these terms as they relate to particular circumstances may be subject to interpretation and differing viewpoints. In applying the procedures, therefore, a taxpayer should consult with a US tax advisor.

If the answer to the question in the third step is yes, is the safe harbor language described above, as provided in the regulations, effective in all transaction documents prior to any US tax statement being made to the taxpayer?

These procedures should be adopted and followed with respect to any matter, transaction, or arrangement engaged in or undertaken by a taxpayer. The scope of the term "transaction" may include many arrangements that would not come under a common understanding of the term. The term "transaction" may include any investment, entity, plan, or arrangement, and any series of steps carried out as part of a plan.

In light of this potentially broad interpretation, we advise compliance with the regulations on an ongoing basis for any amendments to existing agreements and modifications to consummated transactions.

The procedures are as follows:

First, determine whether any person or entity will reflect a deduction, credit, or other tax benefit on a US income tax or information return as a result of the arrangement or transaction. As a caution, it

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The safe harbor language permitting the taxpayer to disclose the federal income tax treatment and tax structure of the transaction to any person generally must have been in effect from the commencement of discussions with respect to the transaction.

should be noted that a party to an arrangement may be a nominee or agent for another, a partnership or other entity treated as a flow-through for US tax purposes, or a non-US controlled foreign corporation, the US shareholders of which may benefit from a deduction at the corporate level.

Thus, in determining whether any person will reflect a deduction or credit on a US income tax or information return, consideration should be given to whether the direct participant in the transaction is either a nominee, agent, or flow-through or other entity, the nature of which will cause the results of the transaction to be reflected on another's US income tax or information return.

Second, with respect to the persons or entities identified in the first procedure above, who may reflect a US tax benefit on a US income tax or information return, has anyone made a US tax statement to the person or entity (or to one of their representatives)? A US tax statement generally is advice, an opinion, or other statement concerning the US tax treatment of some aspect of the transaction.

Third, if the answer to the question in the second procedure is yes (*i.e.*, a US tax statement has been made to a person or entity who will reflect a US tax benefit from the transaction on a US income tax or information return), is that person or entity subject to an agreement or understanding to keep the US tax treatment or tax structure of the transaction confidential?

The understanding, arrangement, or agreement with respect to confidentiality can be oral or written and need not be enforceable. In addition, the confidentiality provisions need not be specific to the tax treatment. General confidentiality provisions can encompass tax aspects of transactions.

Fourth, if the answer to the question in the third procedure is yes, is the safe harbor language described above, as provided in the regulations, effective in all transaction documents prior to any US tax statement being made to the taxpayer?

It should be noted that the safe harbor language permitting the US taxpayer to disclose the US federal income tax treatment and tax structure of the transaction to any person generally must have been in effect from the commencement of discussions with respect to the transaction. In the context of certain acquisition or disposition transactions, as noted above, there is some flexibility in that the ability to disclose need not be in place prior to the earliest of: (i) the date on which the definitive agreements have been signed, (ii) the date of the public announcement of discussions with respect to the transaction, or (iii) the date of the public announcement of the agreement with respect to the transaction.

Fifth, if the answer to the question in the fourth procedure above is no, including where the safe harbor language was not in place in a timely fashion, the US taxpayer must file IRS Form 8886 and retain related documents as described above, and the material advisor must also comply with the list maintenance and document retention requirements described above.

In light of the broad dissatisfaction with the regulations, including complaints with respect to ambiguities in their intended scope, it is possible that the regulations will be modified or at least clarified. In addition, various amendments to the Code have been proposed which would, if adopted, impose additional requirements and significantly increase the penalties that will apply in the case of a failure to comply with the requirements of the regulations. Therefore, taxpayers and their advisors should closely monitor developments with respect to these new regulations. ❏

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