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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR (LMSB), CC:LM:CTM:

FROM: Associate Chief Counsel (Passthroughs and Special Industries), CC:PSI

SUBJECT:

This Field Service Advice responds to your memorandum dated March 15, 2001. In accordance with I.R.C. § 6110(k)(3), this Field Service Advice should not be cited as precedent.

LEGEND

Taxpayer =

Agency =

Certificate =

Manufacturing Certificate =

Product =

Category 1 =

Category 2 =

Category 3 =

Category 4 =

Category 5 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

ISSUES

1. Is the Certificate issued by the Agency to the Taxpayer for the Product a section 197 intangible?

2. If so, what, if any, of the Taxpayer's identified costs may be amortized under section 197(a)?[1]

CONCLUSIONS

1. Assuming the term of the Certificate is 15 years or more and not subject to the exception from section 197 for separately acquired intangibles under section 197(e)(4)(D), the Taxpayer's Certificate is a right granted by a

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1. Unless otherwise indicated, all "section" references are to the I.R.C.

governmental unit and is treated as a section 197 intangible under section 197(d)(1)(D).

2. Only those costs incurred by the Taxpayer in connection with acquisition of the Certificate held in connection with its trade or business that are required to be capitalized under section 263(a) may be amortized under section 197(a). Depending upon the development of additional facts and analysis, certain identified costs may be treated as pre-production costs of the Product under section 263A or, alternatively, allowable as a credit or deduction under sections 41 and 174, respectively.

FACTS

The Taxpayer manufactures j products including k. The Product is one of the Taxpayer's newest k. Development and certification of the Product took approximately a years. On b, the Taxpayer applied for a Certificate for the Product. The Taxpayer and the Agency developed a certification plan specifying the certification requirements. During c, the Taxpayer began development activities on the Product. In d, the Taxpayer completed several Products for Agency certification testing. On e, the first m of an Agency certification Product took place. In f, the Taxpayer received an Agency Certificate for the Product. On g, the first Product was delivered to a customer.

The Agency applies a multi-step certification process for new k. At each step in the certification process, Agency employees or their representatives evaluate materials, designs and data submitted by k manufacturers to determine whether Agency regulatory requirements have been satisfied. Upon making the required showing, the Agency issues the appropriate certificate.

A Certificate is considered to include the type design, the operating limitations, the certificate data sheet, the applicable regulations with which records compliance, and any other conditions or limitations prescribed for the product. A Certificate allows an k manufacturer the privilege of seeking a Manufacturing Certificate for the approved design. A Certificate may be transferred or licensed and it is effective until surrendered, suspended, revoked, or a termination date is otherwise set by the Agency.

Manufacturing may not begin until a Manufacturing Certificate is issued. Before any particular k may be placed in service, its owner must obtain an l certificate.

The LMSB Examination Division has identified five cost categories relating to the Taxpayer's efforts in obtaining a Certificate for the Product. The first category

consists of Category 1 costs consisting of the salaries of approximately h people who devoted close to 100 percent of their time to the process of obtaining the Agency certification. This group was assigned the responsibility of ensuring that everything needed to obtain the Certificate was identified and completed.

The second category is Category 2 salaries which are the salaries of approximately i Taxpayer employees (engineers & scientists) who each function as a Category 2. A Category 2 is an employee of an k manufacturer who possess detailed knowledge of an k's design based upon their day-to-day involvement in its development. The Category 2 acts as a surrogate of the Agency in examining, inspecting, and testing the k for purposes of its certification. In determining whether a k complies with Agency regulations, a Category 2 is guided by the same requirements, instructions, and procedures as Agency employees.

The third category of costs involves testing. For the Product, the Taxpayer requested that the Product be found in compliance with the Category 3 requirements at the time of certification.

The fourth category are costs charged to various Category 4 categories dealing with the certification process. According to the LMSB Examination Division, the Taxpayer describes Category 4 as an outline of the program activities and elements of the k that allows various levels of detail to be identified, collected, and retrieved.

The fifth category is Category 5 costs of m and lab testing (non-Category 3) which the Taxpayer is required to perform as part of the certification process.

LAW AND ANALYSIS

We note as a preliminary matter that you ask we assume the costs described above do not qualify under either section 41 (for the research credit) or section 174 (as R&D expenditures). For the reasons discussed more fully below, we believe these Code sections are relevant for analyzing the section 197 issue.

ISSUE 1

The first issue concerns whether the costs relating to an Agency Certificate issued to the Taxpayer for its Product qualify as a section 197 intangible.

Section 197(a) provides that a taxpayer is entitled to an amortization deduction for any amortizable section 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible

ratably over the 15-year period beginning with the month in which the intangible was acquired.

Section 197(c)(1) defines the term "amortizable section 197 intangible" to mean any section 197 intangible which is acquired by the taxpayer after the date of enactment of section 197, and which is held in connection with the conduct of a trade or business or an activity described in section 212. Section 197(c)(2) provides that the term "amortizable section 197 intangible" shall not include any "section 197 intangible" which is not described in section 197(d)(1), (D), (E), or (F), and which is created by the taxpayer.

Section 197(d)(1)(D) defines the term "section 197 intangible" to include, among other intangible items, any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof.

Treas. Reg. § 1.197-2(b)(8) provides that section 197 intangibles include any license, permit, or other right granted by a governmental unit (including, for purposes of section 197, an agency or instrumentality thereof) even if the right is granted for an indefinite period or is reasonably expected to be renewed for an indefinite period. These rights include, for example, a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license.

Section 197(e)(4)(D) excepts from the term “section 197 intangible,” to the extent provided in regulations, any right under a contract (or granted by a governmental unit or an agency or instrumentality thereof) if such right has a fixed duration of less than 15 years, or is fixed as to the amount and, without regard to section 197, would be recoverable under a method similar to the unit-of-production method.

Treas. Reg. § 1.197-2(c)(13)(i) provides that section 197 intangibles do not include any right under a contract or any license, permit, or other right granted by a governmental unit if the right is acquired in the ordinary course of a trade or business (or an activity described in section 212) and not as part of a purchase of a trade or business; is not described in section 197(d)(1)(A), (B), (E), or (F); is not a customer-based intangible, a customer-related information base, or any other similar item; and either has a fixed duration of less than 15 years; or is fixed as to the amount and the adjusted basis thereof is properly recoverable (without regard to Treas. Reg. § 1.197-2) under a method similar to the unit-of-production method.

Treas. Reg. § 1.197-2(d)(2)(i) provides that, except as provided in § 1.197-2(d)(2)(iii), amortizable section 197 intangibles do not include any section 197 intangible created by the taxpayer (a self-created intangible). Treas. Reg.

§ 1.197-2(d)(2)(ii) defines a self-created intangible as an intangible created by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the contracted creation, production, development, or improvement occurs. However, Treas. Reg. § 1.197-2(d)(2)(iii)(A) provides that the exception for self-created intangibles does not apply to any section 197 intangible described in section 197(d)(1)(D).

The holder or licensee of a Certificate has a privilege that entitles the holder or licensee to obtain a Manufacturing Certificate for the product. The Taxpayer cannot sell the Product without the Manufacturing Certificate. The facts do not specify the term of the Certificate, but assuming the term of the certificate is indefinite or at least 15 years or more, and that the exception for separately acquired intangibles under section 197(e)(4)(D) would not apply, we believe that the Agency Certificate is a section 197 intangible under section 197(d)(1)(D).

ISSUE 2

The second issue concerns what costs, if any, of the Taxpayer's identified costs may be amortized under section 197(a).

Section 197 allows an amortization deduction only for capitalized costs of an amortizable section 197 intangible and does not apply to amounts that are not chargeable to capital account and are otherwise currently deductible. Treas. Reg. § 1.197-2(a)(1), (a)(3), and (f)(3).

Section 263(a)(1) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 263(a)(1)(B) provides that section 263(a) does not apply to research and experimental expenditures deductible under section 174.

Section 263A(a)(1) provides that in the case of any property to which section 263A applies, any costs described in section 263A(a)(2), in the case of property that is inventory in the hands of the taxpayer, shall be included in inventory costs, and in the case of any other property, shall be capitalized. Section 263A(a)(2) provides that the costs with respect to any property are the direct costs of such property, and such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property. Any cost which (but for section 263A(a)) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in section 263A(a)(2). Section 263A(c)

provides that section 263A does not apply to any amount allowable as a deduction under section 174.

Section 174(a)(1) provides that a taxpayer may treat research or experimental expenditures that are paid or incurred during the taxable year in connection with a trade or business as expenses that are not chargeable to capital. The expenditures so treated shall be allowed as a deduction.

Section 41(a) provides, for purposes of section 38, the research credit for the taxable year shall be an amount equal to the sum of 20 percent of the excess (if any) of the qualified research expenses for the taxable year, over the base amount, and 20 percent of the basic research payments determined under section 41(e)(1)(A). Under section 41(d)(1)(A), the definition of the term "qualified research" encompasses research with respect to which expenditures may be treated as expenses under section 174.

Further factual development is needed in this case to determine whether any of the identified costs are subject to section 263A, or, alternatively, may be allowable as a credit or a deduction under sections 41 or 174, respectively, before we can determine what costs are capitalized to the section 197 intangible and amortized under section 197(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

With regard to the section 263A issue, the Associate Chief Counsel (Income Tax & Accounting) recommends that a request for a technical advice memorandum under Rev. Proc. 2001-2, 2001-1 I.R.B. 79, be submitted. See CCDM 35.2.7.4.2. Any request for a technical advice memorandum dealing with sections 263(a) and 263A should provide an analysis of the deductibility of the costs under section 174.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call at if you have any further questions.

By: /s/ Susan Reaman
Chief, Branch 5
Office of Associate Chief Counsel
(Passthroughs and Special Industries)