26 CFR 601.204: Changes in accounting periods and in methods of accounting.

(Also Part I, §§ 165, 167, 263, 263A, 446, 481; 1.165-2, 1.167(a)-3, 1.263(a)-2, 1.263A-2, 1.446-1, 1.481-4.)

Rev. Proc. 97-35

SECTION 1. PURPOSE

.01 This revenue procedure describes three alternative methods of accounting for package design costs: (1) the capitalization method (*see* section 5.01 of this revenue procedure), (2) the design-by-design capitalization and 60-month amortization method (*see* section 5.02 of this revenue procedure), and (3) the pool-of-cost capitalization and 48-month amortization method (*see* section 5.03 of this revenue procedure). A taxpayer may change to or adopt any one of these three methods. The procedures for a taxpayer to change to one of these three methods are provided in Rev. Proc. 97–37, page 18, which provides simplified and uniform procedures to obtain automatic consent to make this and other changes in methods of accounting. This revenue procedure modifies and supersedes Rev. Proc. 90–63, 1990–2 C.B. 664.

.02 The three methods of accounting for package design costs described in this revenue procedure are the same methods of accounting that were described in Rev. Proc. 90–63. Accordingly, a taxpayer that properly changed to or adopted one of these methods pursuant to Rev. Proc. 90–63 is not required to change its method of accounting to comply with this revenue procedure.

SECTION 2. DEFINITIONS

For purposes of this revenue procedure, the terms “package design” and “package design cost” have the meanings provided in Rev. Rul. 89–23, 1989–1 C.B. 85. If the taxpayer develops the package design, the term includes the cost of materials, labor, and overhead associated with the design, including all design exploration and study (for example, the development of any related design which, although abandoned, advances the development of the design selected), refinement of the basic design selected, testing, and preparation of the final master comprehensive design. If an independent contractor performs the work, the term includes all billings related to the development of the particular package, including all design exploration and study (for example, the development of any related design which, although abandoned, advances the development of the design selected), refinement of the basic design selected, testing, and preparation of the final master comprehensive design. If the taxpayer purchases the package, the term includes the purchase price. The costs associated with coupon inserts, refund offers, and other short-lived promotion-related changes are specifically excepted from the definition of “package design cost.”

SECTION 3. BACKGROUND

.01 Section 263(a) of the Internal Revenue Code provides that no deduction is allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)–2 of the Income Tax Regulations includes in its examples of capital expenditures the costs of acquiring property having a useful life substantially beyond the tax year.

.02 An expenditure generally must be capitalized under § 263 if the expenditure creates, enhances, or is part of the cost of acquiring a tangible or intangible asset having a useful life that extends substantially beyond the end of the tax year in which the expenditure is incurred. *See INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992); *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971), 1971-2 C.B. 116; *Central Texas Savings and Loan Association v. United States*, 731 F.2d 1181 (5th Cir. 1984); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983); and *Cleveland Electric Illuminating Company v. United States*, 7 Cl. Ct. 220 (1985). Generally, taxpayers must capitalize package design costs incurred prior to

January 1, 1987 under § 263 because those costs create intangible assets having useful lives that extend substantially beyond the end of the tax year in which the costs are incurred. *See* Rev. Rul. 89-23.

.03 Section 263A, enacted by the Tax Reform Act of 1986, provides, in part, for the capitalization of certain direct and indirect costs with respect to real or tangible personal property produced by the taxpayer. All costs that are incurred with respect to real or tangible personal property that the taxpayer produces are to be capitalized with respect to the property. The term "produce" includes construct, build, install, manufacture, develop, improve, create, raise, or grow. For purposes of §263A, "tangible personal property" includes a film, sound recording, video tape, book, or similar property embodying words, ideas, concepts, images, or sounds (*see* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–308 (1986), 1986–3 (Vol. 4) C.B. 308) without regard to whether the property is treated as tangible or intangible under other provisions of the Code. *See* § 1.263A-2(a)(2)(ii). Section 263A and the regulations thereunder require that costs incurred after December 31, 1986 in connection with the development and design of product packages must be capitalized. *See* Rev. Rul. 89–23.

.04 As stated in Rev. Rul. 89–23, package designs generally do not have an ascertainable useful life, and thus no depreciation or amortization is allowed under § 167 and the regulations thereunder. *See* § 1.167(a)–3. Only when such a package design is abandoned may the capitalized costs be deducted. *See* § 165 and §1.165–2(a).

.05 Thus, taxpayers are generally required under the Code and regulations to use the capitalization method of accounting for package design costs described in section 5.01 of this revenue procedure. However, to minimize disputes regarding the accounting for package design costs, the Internal Revenue Service, as a matter of administrative convenience, will allow a taxpayer that complies with the requirements of this revenue procedure to choose one of two alternative methods of accounting for package design costs:

(1) the capitalization and 60-month amortization method described in section 5.02 of this revenue procedure, determined on a design-by-design basis for all package designs or;

(2) the capitalization and 48-month amortization method described in section 5.03 of this revenue procedure, determined on a pool-of-cost basis for all package design costs.

SECTION 4. SCOPE

This revenue procedure applies to a taxpayer that wants to change to or adopt a method of accounting for package design costs. A change in method of accounting for package design costs made pursuant to this revenue procedure does not affect the taxpayer's method of accounting for intangible property other than package designs described in section 2 of this revenue procedure.

SECTION 5. ALTERNATIVE METHODS OF ACCOUNTING

.01 *The capitalization method.*

(1) *Description of method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the capitalization method constitutes a permissible method of accounting. Under the capitalization method, the taxpayer must capitalize the costs of developing (or modifying) any package design if the asset created by those costs has no ascertainable useful life or an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. If the asset created by the costs has an ascertainable useful life, the taxpayer may amortize the costs ratably over the useful life, beginning with the month the package design (or modification to the design) is placed in service. If the asset created by the costs has no ascertainable useful life, the taxpayer may deduct the costs only upon the disposition or abandonment of the package design (or modification to the design). *See* Rev. Rul. 89-23.

(2) *Computation of basis.* The basis of each package design (or modification to the design) subject to capitalization is determined by applying the provisions of § 263 and the regulations thereunder to costs incurred prior to January 1, 1987, and § 263A and the regulations thereunder to costs incurred after December 31, 1986 (regardless of the tax year the design (or modification to the design) is placed in service). The costs required to be capitalized are described in section 2 of this revenue procedure.

.02 *The design-by-design capitalization and 60-month amortization method.*

(1) *Description of method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the design-by-design capitalization and 60-month amortization method constitutes a permissible method of accounting. Under the design-by-design capitalization and 60-month amortization method, the taxpayer must capitalize the costs of developing (or modifying) any package design if the asset created by those costs has no ascertainable useful life or an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. The taxpayer must amortize the basis of any package design (or modification to the design) subject to capitalization over a period of 60 months. Thus, in computing taxable income, the basis of each package design (or modification to the design) subject to capitalization is allowed as a deduction ratably over a 60-month period, beginning with the month the design (or modification to the design) is treated as placed in service. *See* section 5.02(3) of this revenue procedure. If the package design (or modification to the design) is disposed of or abandoned within the 60-month period, the taxpayer is permitted to deduct the unamortized portion of the basis of the design (or modification to the design) in the tax year of disposition or abandonment.

(2) *Computation of basis.* Under the design-by-design capitalization and 60-month amortization method, the basis of each package design (or modification of the design) subject to capitalization must be determined by applying the provisions of § 263 and the regulations thereunder to costs incurred prior to January 1, 1987, and § 263A and the regulations thereunder to costs incurred after December 31, 1986 (regardless of the tax year the design (or modification to the design) is placed in service). The costs required to be capitalized are described in section 2 of this revenue procedure.

(3) *Half-year convention.* Under the design-by-design capitalization and 60-month amortization method, the amortization allowance for each package design

(or modification to the design) subject to capitalization must be determined by treating a design (or modification to the design) placed in service during the tax year as placed in service on the mid-point of the tax year. If the tax year in which the package design (or modification to the design) is placed in service is 12 full months, the design (or modification to the design) is treated as placed in service on the first day of the seventh month of the tax year. For guidance in computing the amortization allowance under the design-by- design capitalization and 60-month amortization method when a package design (or modification to the design) is placed in service in a taxable year of less than 12 months (a short taxable year), see Rev. Proc. 89-15, 1989-1 C.B. 816.

.03 *The pool-of-cost capitalization and 48-month amortization method.*

(1) *Description of method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the pool-of-cost capitalization and 48-month amortization method constitutes a permissible method of accounting. Under the pool-of-cost capitalization and 48-month amortization method, the taxpayer must capitalize all its package design costs and amortize the costs over a period of 48 months. Thus, in computing taxable income, package design costs incurred during the tax year are allowed as a deduction ratably over a 48-month period, beginning with the month the costs are treated as incurred. See section 5.03(3) of this revenue procedure. The taxpayer may not deduct the unamortized portion of the cost of a package design (or modification to the design) if the design (or modification to the design) is never placed in service or is disposed of or abandoned within the 48-month period.

(2) *Costs subject to capitalization.* All package design costs are subject to capitalization without regard to whether the costs create a package design (or modification to the design) having an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. Thus, all package design costs incurred prior to January 1, 1987 that would be capitalized under § 263 and the regulations thereunder but for the fact that the costs create a package design (or modification to the design) having an ascertainable useful life that does not extend substantially beyond the end of the tax year in which the costs are incurred must be capitalized. All package design costs incurred after December 31, 1986 that would be capitalized under § 263A and the regulations thereunder but for the fact that the costs create a package design (or modification to the design) having an ascertainable useful life that does not extend substantially beyond the end of the tax year in which the costs are incurred must be capitalized. The costs required to be capitalized are described in section 2 of this revenue procedure.

(3) *Half-year convention.* Under the pool-of-cost capitalization and 48-month amortization method, the amortization allowance for package design costs must be determined by treating all package design costs incurred during the tax year as incurred on the mid-point of the tax year. If the tax year in which the package design costs are incurred is 12 full months, the costs are treated as incurred on the first day of the seventh month of the tax year. For guidance in computing the amortization allowance under the pool-of-cost capitalization and 48-month amortization method when package design costs are incurred in a taxable year of less than 12 months (a short taxable year), see Rev. Proc. 89–15.

SECTION 5. CHANGING PACKAGE DESIGN COSTS METHOD

.01 *Automatic change.* A taxpayer wanting to change its method of accounting for package design costs must follow the provisions in Rev. Proc. 97-37.

.02 *Section 481(a) adjustment.*

(1) *Change to the capitalization method.* If the taxpayer is changing its method of accounting for package design costs to the capitalization method, the § 481(a) adjustment (which will be positive) will restore to income the total amounts deducted or amortized in tax years prior to the year of change with respect to all package designs (or modifications to designs) subject to capitalization and not abandoned as of the first day of the tax year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to designs (or modifications to designs) which had an ascertainable useful life on the date the designs (or modifications to the designs) were placed in service. The § 481(a) adjustment is the difference at the beginning of the tax year of change between the basis of all such package designs (or modifications to designs) determined under the taxpayer's present method of accounting and the basis redetermined under the capitalization method.

(2) *Change to the design-by-design capitalization and 60-month amortization method.* If the taxpayer is changing its method of accounting for package design costs to the design-by-design capitalization and 60-month amortization method, the § 481(a) adjustment is equal to the total amounts deducted or amortized in tax years prior to the year of change with respect to all package designs (or modifications to designs) subject to capitalization and not abandoned as of the first day of the tax year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to such designs (or modifications to designs) had the design-by-design capitalization and 60-month amortization method been used.

(3) *Change to the pool-of-cost capitalization and 48-month amortization method.* If the taxpayer is changing its method of accounting for package design costs to the pool-of-cost capitalization and 48-month amortization method, the § 481(a) adjustment is equal to the total amounts deducted or amortized in tax years prior to the year of change with respect to all package design costs treated as incurred during the tax years prior to the year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to such costs had the pool-of-cost capitalization and 48-month amortization method been used.

SECTION 6. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Income Tax and Accounting) CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 90-63, 1990-2 C.B. 664, is modified, and as modified, is superseded. However, see the transition rules in section 13.02 of Rev. Proc. 97-37.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective on August 18, 1997.

DRAFTING INFORMATION

This revenue procedure was drafted in the Office of Assistant Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Robert A. Testoff on (202) 622-4800 (not a toll free call).