OFFICE OF
CHIEF COUNSEL

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

MEMORANDUM FOR: DISTRICT COUNSEL, NEW JERSEY DISTRICT
CC:NER:NJD
ATTN: PATRICIA Y. TAYLOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: PHARMACEUTICAL INDUSTRY
Pre-Launch Costs

This memorandum responds to your undated request, received here on May 18, 1999. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

ISSUE:

Whether certain marketing and advertising costs incurred before regulatory approval of a product for sale are ordinary and necessary business expenses deductible under I.R.C. ' 162.

CONCLUSION:

On the facts presented, the costs appear indistinguishable from those costs traditionally associated with ordinary business advertising and thus are ordinary and necessary business expenses under section 162.

FACTS:

Prior to the commercial sale, production, or distribution of certain products, the regulatory approval thereof by the government must be obtained. While that approval is pending, certain marketing costs are often incurred; for example, campaigns raising consumer awareness of the purported need for the product and/or advertisements that the product will be Acoming soon.@ In addition, some training symposia and literature in the product=s use may be offered to certain distributors and professionals. The cost of developing an initial marketing strategy may also be incurred before the product is actually available to sell.

LAW AND ANALYSIS:

Section 162 allows the deduction of ordinary and necessary expenses paid or incurred in carrying on a trade or business. Advertising and other selling expenses, under the regulations, are specifically set out as deductible business expenses. Treas. Reg. ' 1.162-1(a). Moreover, the costs of institutional or goodwill advertising, which keeps the taxpayer=s name before the consumer, are deductible as ordinary and necessary expenses provided the expenditure is related to business taxpayer might expect to receive in the future. Denise Coal Co. v. Commissioner, 29 T.C. 528, 553 (1957), aff=d and rev=d on other issues, 271 F.2d 930 (3d Cir. 1959).

Section 263(a), however, provides that no deduction is allowed for permanent improvements and betterments made to increase the value of property. The Supreme Court, in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), concluded that certain legal and professional fees incurred by a target corporation to facilitate a merger created significant long-term benefits for the taxpayer and, thus, were capital expenditures. The Court specifically rejected the notion that its earlier decision in Commissioner v. Lincoln Savings and Loan Assn., 403 U.S. 345 (1971), should be read as holding Athat only expenditures that create or enhance separate and distinct assets are to be capitalized@ under section 263. Id. at 86-87 (emphasis in original).

Capitalization of advertising costs is required, nevertheless, if the predominant purpose served thereby is the expenditure=s contribution to acquisition of a capital asset; for example, where the expenditure is designed to allay the fears and apprehensions of the public where that otherwise unmitigated concern could result in Aroadblocks and delays@ in issuance of a necessary permit or license for the construction and operation of a nuclear power plant. Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220, 232 (1985). In those circumstances, the advertising costs are really just a part of the cost of acquiring the construction permit and operating license. This determination is a question of fact which is to be resolved from all the evidence and in light of the burden of proof. Id. at 231. Your assessment of the operative facts in this instance, which is controlling for present purposes, of course, finds the advertising in issue here to be unlike that which is necessarily capitalized.

The Service has consistently maintained the position that the INDOPCO ruling did not change the fundamental legal principles for determining whether a particular expenditure can be deducted or instead must be capitalized. To that end, Rev. Rul. 92-80 specifically states that the INDOPCO decision does not affect the treatment of advertising costs under section 162. Rev. Rul. 92-80, 1992-2 C.B. 57. Moreover, that ruling makes clear that such expenditures are still generally deductible even though those costs may still have some future benefit to the taxpayer.[1]

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

In this case, in light of your specific factual determination that the advertising expenses in issue are indistinguishable from Athose costs traditionally associated with ordinary business advertising,@ we agree that an ordinary deduction should be allowed. See also RJR Nabisco v. Commissioner, T.C. Memo. 1998-252 [redacted].
Despite this position, we do not wish to foreclose the possibility of other necessarily capital pre-launch expenditures in this industry where such costs are comparable in nature to those described in Cleveland Electric. Those would be advertising costs which are geared towards mobilizing opinion as an aid towards regulatory approval. In the context of FDA actions, however, unlike the nuclear plant regulatory process involved in Cleveland Electric, we presume such a situation is rather unlikely to present itself in reality.

DEBORAH A. BUTLER

By:
RICHARD L. CARLISLE
Chief
Income Tax & Accounting Branch
Field Service Division

[1] Just like with advertising, the existence of some resultant future benefit from other expenditures as well is not fatal for current deduction treatment in and of itself. See Rev. Rul. 94-12, 1994-1 C.B. 36 (incidental repairs deductible); Rev. Rul. 94-77, 1994-2 C.B. 19 (severance pay deductible); Rev. Rul. 96-62, 1996-2 C.B. 9 (training costs deductible).