Office of Chief Counsel
Internal Revenue Service

Memorandum

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to: Roy Metcalfe
Financial Products Team Manager 1909, Territory 1

from: Suzan Akyali
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subject: **Taxpayer:**
Tax Years:
UIL: 162.00-00, 263A.00-00

INTRODUCTION:

The Large Business and International ("**LB&I**") operating division of the Internal Revenue Service (the "**Service**") is currently examining the U.S. federal income tax returns of (the "**Taxpayer**") for the taxable years ended . This memorandum responds to your request regarding the U.S. federal income tax treatment of the commitment fees paid by the Taxpayer in connection with a revolving credit facility. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us. If the facts are different from the facts set forth below, you should immediately advise us.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client and attorney work product privileges. Accordingly, this memorandum is not to be distributed to the Taxpayer. If disclosure becomes necessary, please contact this office for our views.

ISSUE:

The issue is whether the Taxpayer is entitled to deduct the quarterly commitment fees paid on the Taxpayer's revolving credit facility in .

FACTS:

The Taxpayer is an accrual basis taxpayer engaged in the business of . In the course of its business, the Taxpayer entered into a revolving credit agreement (the "**Agreement**") on with a consortium of lenders for a term of five years. Under the Agreement, the Taxpayer secured the right to utilize a total of through a revolving line of credit and letters of credit, all of which may be used for general corporate purposes and no more than of which may be used for the issuance of letters of credit. The line of credit allowed the Taxpayer to borrow at a rate that referenced the prevailing market interest rate as of the time of borrowing. The Agreement allowed the Taxpayer to prepay outstanding principal and interest. All amounts outstanding had to be repaid, and outstanding letters of credit terminated, at the end of the Agreement. The Agreement allowed the Taxpayer to request an extension of the termination date.

Under the Agreement, the Taxpayer was required to pay a quarterly commitment fee (the "**Commitment Fee**") in arrears on the last day of each calendar quarter and on the termination date of the Agreement. Each Commitment Fee was computed based upon the average daily unused amount of the total commitment during the most recent previous quarter multiplied by a percentage (a fraction of one percent), which varied based upon the Taxpayer's credit rating at that time as determined by either . The Agreement allowed the Taxpayer to reduce the amount of or terminate in whole the unused portions of the lenders' respective commitments without penalty, but the Taxpayer did not exercise these options.

Pursuant to the Agreement, the Taxpayer's failure to pay a Commitment Fee (or any other fee or interest due under the Agreement) when due would constitute an "event of default" under the Agreement. Failure to remedy the default would provide grounds for the lenders to accelerate all obligations under the Agreement and could ultimately cause a termination of the Agreement.

The Taxpayer paid Commitment Fees of $ in and $ in , which it currently deducted. In addition to the Commitment Fees at issue, the Taxpayer paid other fees in connection with the Agreement, including letter of credit fees and fronting fees. These fees are not addressed in this memorandum.

LAW AND ANALYSIS:

Section 162(a)[1] provides generally that taxpayers may deduct all the ordinary

[1] All section references in this memorandum are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. See also § 1.162-1(a). To qualify as an allowable deduction under § 162(a), an item must (1) be paid or incurred during the taxable year; (2) be for carrying on a trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 352 (1971). The term "ordinary" refers to an expenditure that is normal, usual, or customary. Deputy v. du Pont, 308 U.S. 488, 495 (1940). An expenditure may be ordinary if it is commonly and frequently incurred in the type of business involved. Id. (citing Welch v. Helvering, 290 U.S. 111, 114 (1933)). The term "necessary" means appropriate and helpful to the development of the taxpayer's business. Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (quoting Welch, 290 U.S. at 113); Commissioner v. Heininger, 320 U.S. 467, 471 (1943).

Under § 161, if a cost is a capital expenditure, the capitalization rules of § 263 take precedence over the deduction rules of § 162. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974). Therefore, a capital expenditure cannot be deducted under §162, regardless of whether the expenditure is ordinary and necessary in carrying on a trade or business.

Section 461(a) provides that the amount of any deduction or credit shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. The regulations under § 461 also require that a taxpayer's method of accounting clearly reflect income.

Section 1.461-1(a)(2)(i) cites to §§ 162 and 263 and provides that if an expenditure results in the creation of an asset having a useful life that extends beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.

We believe that the Taxpayer's Commitment Fees are commonly and frequently incurred in the type of business conducted by the Taxpayer and are appropriate and helpful to the development of the Taxpayer's business, and therefore the payment of the Commitment Fees is an ordinary and necessary expense under § 162. Accordingly, the payment of the Commitment Fees is deductible as an expense under § 162(a), subject to the capitalization rules of § 263(a).

On January 5, 2004, the Service and Treasury Department published final regulations under § 263(a) in T.D. 9107, 69 Fed. Reg. 436, reprinted in 2004-7 I.R.B. 447, which explain how § 263(a) applies to amounts paid to acquire, create or enhance intangible assets and are generally effective for amounts paid or incurred on or after December 31, 2003. Accordingly, this memorandum analyzes the Commitment Fees under the final regulations.

Section 263(a) generally provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to

increase the value of any property or estate or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-4 provides rules for applying § 263(a) to amounts paid or incurred to acquire or create (or to facilitate the acquisition or creation of) intangible assets.[2] It identifies "categories of intangibles for which capitalization is required." Preamble to T.D. 9107, II.A. An amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the Service publishes guidance requiring capitalization of the expenditure. Id.

Section 1.263(a)-4(b)(1) provides that a taxpayer must capitalize an amount paid to: (i) acquire an intangible (see § 1.263(a)-4(c)); (ii) create an intangible described in § 1.263(a)-4(d); (iii) create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3); (iv) create or enhance a future benefit identified in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalization is required under this section; and (v) facilitate (within the meaning of § 1.263(a)-4(e)(1)) an acquisition or creation of an intangible.

A. Amounts paid to acquire an intangible in a purchase or similar transaction

Section 1.263(a)-4(c)(1) provides that, in general, a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. See also § 1.263-4(b)(1)(i).

In this case, the Taxpayer did not pay a Commitment Fee to another party to acquire an intangible in a "purchase or other similar transaction." As a result, the Commitment Fee does not constitute an amount paid to acquire an intangible within the meaning of § 1.263(a)-4(c).

B. Amounts paid to create an intangible

Section 1.263(a)-4(d)(1) generally provides that a taxpayer must capitalize amounts paid to create an intangible described in § 1.263(a)-4(d). See also § 1.263(a)-4(b)(1)(ii). Sections 1.263(a)-4(d)(2) through (d)(9) provide that a taxpayer must capitalize amounts paid to the following categories of intangibles: (2) financial interests; (3) prepaid expenses; (4) memberships and privileges; (5) rights obtained from a government agency; (6) contract rights; (7) contract terminations; (8) benefits arising from the provision, production or improvement of real property; and (9) defense or

[2] Section 1.263(a)-5, also added by T.D. 9107, provides rules for applying § 263 to amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, a borrowing, and certain other transactions.

perfection of title to intangible property. See §§ 1.263(a)-4(d)(2) through (9). The determination of whether an amount is paid to create an intangible described in § 1.263(a)-4(d) is to be made based on all of the facts and circumstances. Section 1.263(a)-4(d)(1). Among the financial interests listed in § 1.263(a)-4(d)(2) are financial instruments such as options. See § 1.263(a)-4(d)(2)(i)(C)(7).

The Commitment Fee is not an amount paid to create one of the types of intangibles that are listed in categories (2) through (9) of § 1.263(a)-4(d). With respect to category (2) of § 1.263(a)-4(d), as relevant here, the payments of the Commitment Fee in this case do not involve any of the financial interests described in § 1.263(a)-4(d)(2)(i) except, possibly, options described in § 1.263(a)-4(d)(2)(i)(C)(7). For the reasons described below, the Commitment Fees in this case are not required to be capitalized under § 1.263(a)-4(d)(2)(i)(C)(7).

If the Commitment Fee payments were made to create an option, they would be required to be capitalized under § 1.263(a)-4(d)(2)(i)(C)(7). An option includes an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property). Section 1.263(a)-4(d)(2)(i)(C)(7). An option is the right, but not the obligation, to purchase or sell a security or property at a fixed price (strike price) and by a specified time (expiration date). See Federal Home Loan Mortgage Corporation v. Commissioner, 125 T.C. 248, 259-60 (2005); Estate of Franklin v. Commissioner, 64 T.C. 752, 762 (1975), aff'd on other grounds Franklin's Estate v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); U.S. Freight Company v. United States, 422 F.2d 887, 894 (Ct. Cl. 1970). Compare Rev. Rul. 81-160, 1981-1 C.B. 312 (a loan commitment fee in the nature of a standby charge is similar to the cost of an option).

The determination of whether an amount is paid to create an intangible described in § 1.263(a)-4(d) is to be made based on all of the facts and circumstances. Section 1.263(a)-4(d)(1). Under the Agreement, it appears that the payment of a Commitment Fee did not create an option within the meaning of § 1.263(a)-4(d). Rather, each Commitment Fee was related to the rights and benefits maintained by the Taxpayer during the three-month period prior to the date that the payment was due under the Agreement. However, even if the payment of a Commitment Fee was an amount paid to create an option, we believe such option would only relate to the three-month period preceding the payment date (and would not extend beyond the close of the taxable year), and accordingly the timing of the Taxpayer's deduction under the Taxpayer's method of accounting would clearly reflect income on the facts of this case.

C. Amounts paid to create or enhance a separate and distinct intangible asset

In general, a taxpayer is required to capitalize an amount paid to create or enhance a separate and distinct intangible asset. See § 1.263(a)-4(b)(1)(iii). Section 1.263(a)-4(b)(3)(i) provides that the term "separate and distinct intangible asset" means a property interest of ascertainable and measurable value in money's worth that is

subject to protection under applicable state, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.

Here, the payment of a Commitment Fee under the Agreement is not an amount paid to create or enhance a separate or distinct intangible asset within the meaning of § 1.263(a)-4(b)(3) because the payment of the Commitment Fee at issue is not made to create a separate property interest as defined in § 1.263(a)-4(b)(3)(i). In addition, the Commitment Fee does not enhance such property interest or any other specified intangible asset. Rather, based on the facts described, the Commitment Fee is more in the nature of a fee necessary to maintain, not enhance, the Taxpayer's revolving credit agreement. As a result, the Commitment Fees are not required to be capitalized under § 1.263(a)-4(b)(1)(iii).

D. Amounts paid to facilitate an acquisition or creation of an intangible asset

A taxpayer must capitalize amounts paid to facilitate (within the meaning of § 1.263(a)-4(e)(1)) an acquisition or creation of an intangible. Section 1.263(a)-4(b)(1)(v). An amount is generally paid to facilitate the acquisition or creation of an intangible if the amount is paid in the process of investigating or otherwise pursuing the transaction. Section 1.263(a)-4(e)(1)(i). 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. Id. Examples of amounts paid to facilitate the acquisition or creation of an intangible include fees paid to attorneys, accountants and appraisers. See e.g., § 1.263(a)-4(e)(5), Ex. 1 (outside legal counsel fees), Ex. 3 (outside legal counsel fees), and Ex. 4 (attorney, accountant and appraisal fees).

The payment of a Commitment Fee does not facilitate (within the meaning of § 1.263(a)-4(e)(1)) an acquisition or creation of an intangible because it is not a payment made in investigating or otherwise pursuing the transaction. Therefore, § 1.263(a)-4(b)(1)(v) does not apply to the payment of the Commitment Fees.

CONCLUSION:

Under the facts described above, the Taxpayer is not required to capitalize the Commitment Fees under § 263 and may deduct the Commitment Fees under § 162 in the taxable year in which they were incurred under § 461.

PROCEDURAL CONSIDERATIONS:

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 the undersigned at (646) 259-8011 if you have any further questions.

PETER GRAZIANO
Area Counsel
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By: ________________
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