INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.:	TAM-131995-03, CC:ITA:B03

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
State X =
Y =

Date 1 =
Year 1 =
Year 2 =
$a =
$b =
$c =
$d =

$e =
z =

ISSUE:

Whether quarterly facility fees[1] paid in arrears by the Taxpayer in connection with a revolving credit agreement may be deducted when paid under § 162 of the Internal Revenue Code.

CONCLUSION:

The Taxpayer may deduct these facility fees under § 162 in the taxable year in which they were paid.

FACTS:

The Taxpayer, an accrual basis taxpayer, is a State X corporation engaged directly and through its various subsidiaries in the business of Y. In the course of its business, the Taxpayer entered into a revolving credit agreement in Year 1 with a consortium of commercial lenders for a term of z years, under which it secured the right to utilize $a of total credit through a revolving line of credit and letters of credit. On Date 1, the agreement was amended and restated as the Amended and Restated Revolving Credit Agreement ("the Agreement"). Under the Agreement, total credit utilization and remaining credit available was determined with reference to both the revolving credit line and letters of credit. In other words, the total combined amount could not exceed $a. The Agreement allowed the Taxpayer to borrow, prepay, and reborrow during its z-year term. All amounts outstanding had to be repaid, and outstanding letters of credit terminated, at the end of the Agreement.

Under the Agreement, the Taxpayer was required to pay a quarterly facility fee in arrears on the first business day of the next quarter for each calendar quarter and on the termination date of the Agreement. Each quarterly facility fee was computed based upon the average daily amount of the total commitment during the most recent previous quarter multiplied by a percentage, which varied based upon the Taxpayer's credit rating at that time as determined by either Standard and Poor's Ratings Group or Moody's Investors Service, Inc. The Agreement allowed the Taxpayer to reduce the amount of the total commitment or to terminate the total commitment without penalty, but the Taxpayer did not exercise these options. Unless the Taxpayer reduced the total commitment or caused a change in its credit rating, the amount of each quarterly facility fee would remain the same throughout the term of the Agreement regardless of whether the Taxpayer drew down funds against the revolving line of credit or letters of credit. In

[1] The term, "facility fees" as used in this memorandum refers only to facility fees as defined and described in the Taxpayer's Amended and Restated Revolving Credit Agreement, Date 1.

this case, the amount of the quarterly facility fee remained the same throughout the z-year term of the Agreement.

Pursuant to the Agreement, the Taxpayer's failure to pay a facility fee when due (or any other fee or interest due under the Agreement) 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.

While the Taxpayer did not have any revolving credit loans outstanding during the Year 2 taxable year at issue, it had letters of credit outstanding under the Agreement throughout Year 2, ranging from $b to $c. The Taxpayer paid quarterly facility fees of $d in Year 2. For federal income tax purposes, the Taxpayer deducted these fees as paid in Year 2.

In addition to the quarterly facility fees at issue, the Taxpayer paid other fees in connection with the Agreement, including separate letter of credit fees (calculated based on the stated amount of each letter of credit) and letter of credit issuance fees. The Taxpayer also incurred costs in Year 1 in the amount of $e to secure the Agreement, and capitalized and amortized these costs over the z-year term of the Agreement. The separate letter of credit fees, issuance fees, and costs to secure the Agreement are not addressed by this technical advice memorandum.

LAW AND ANALYSIS:

The issue in this case is whether the Taxpayer was entitled to deduct under § 162 the quarterly facility fees imposed under the Agreement at the time they were paid in Year 2. The examining agents contend the facility fees were not deductible in Year 2 because the fees are analogous to the commitment fees or standby charges addressed in Rev. Rul. 81-160, 1981-1 C.B. 312. Under this revenue ruling, the Service reasoned that loan commitment fees are similar to the costs of an option and result in the acquisition of a property right (i.e., the right to use money). Accordingly, the ruling holds that the commitment fees cannot be currently deducted, but may be deducted ratably only when the property right is exercised or as a loss when the right expires. Using this reasoning, the revenue agents argue that the Taxpayer could not deduct any of its facility fees until the Taxpayer drew down a loan under the Agreement or until the rights under the Agreement expired.

The Taxpayer argues that the facility fees are distinguishable from the commitment fees at issue in Rev. Rul. 81-160 and are more akin to maintenance charges which are currently deductible under § 162. The Taxpayer also argues that its facility fees did not create or enhance any separate and distinct asset or produce any significant benefits extending beyond the taxable year in which such costs were incurred. Thus, the Taxpayer concludes that such amounts could not be characterized as capital expenditures under § 263. For the reasons described below, we conclude that the facility fees at issue in this case may be deducted under § 162.

I. Whether the Facility Fees Must Be Treated as Capital Expenditures under § 263

Section 162(a) provides a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. 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 Assn., 403 U.S. 345, 352 (1971). An expense incurred in a taxpayer's business may qualify as ordinary and necessary if it is commonly and frequently incurred in the type of business conducted by the taxpayer, and is appropriate and helpful in carrying on that business, and is not in the nature of a capital expenditure. See Commissioner v. Tellier, 383 U.S. 687, 689 (1966); Deputy v. du Pont, 308 U.S. 488, 495 (1940); Welch v. Helvering, 290 U.S. 111, 113 (1933).

Section 263 prohibits deductions for capital expenditures. 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 1.263(a)-1(b) of the Income Tax Regulations provides that capital expenditures include amounts paid or incurred to add to the value, or substantially prolong the useful life, of property owned by the taxpayer or to adapt property to a new or different use. In addition, § 1.263(a)-2(a) provides that capital expenditures include the costs to acquire property having a useful life substantially beyond the taxable year.[2]

Under these rules, the Supreme Court has held that an expenditure which serves to create or enhance a separate and distinct asset is necessarily capital in nature, and must be capitalized under § 263. See Commissioner v. Lincoln Savings & Loan Ass'n., 403 U.S. 345, 354 (1971). In addition to this "separate and distinct asset" standard, the Supreme Court has also held that costs must be capitalized under § 263 if they generate significant future benefits beyond the year in which the expenditure is incurred. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87-88 (1992).

[2] On January 5, 2004, the Service issued final regulations under § 1.263(a)-4 regarding the deduction and capitalization of amounts paid to acquire and create intangibles. Because the year at issue in this technical advice memorandum predates the effective date of the regulations, these regulations are not discussed or applied in this memorandum.

The Supreme Court has recognized that the "decisive distinctions between current expenses and capital expenditures are those of degree and not kind." INDOPCO, Inc., 503 U.S. at 86, quoting Welch, 290 U.S. at 114. Therefore, careful examination of the particular facts in each case is required.

We believe that the taxpayer's facility fees are appropriate and helpful in carrying on the Taxpayer's business, and that these types of fees are commonly and frequently incurred in the type of business conducted by the Taxpayer. Therefore, these expenditures represent ordinary and necessary expenses within the meaning of § 162. Nevertheless, to qualify for a deduction under § 162, the amounts at issue cannot constitute capital expenditures under § 263. Thus, the facility fees cannot be deducted, and must be capitalized, if they serve to create or enhance a separate and distinct asset or if they generate significant long term benefits for the Taxpayer.

First, we do not believe that the facility fees paid in Year 2 served to create or enhance a separate and distinct asset with a useful life extending substantially beyond the end of the taxable year. Under the terms of the Agreement, each facility fee was due in arrears on the first business day of the subsequent calendar quarter and on the termination date of the Agreement. The amount of each facility fee was based on the total commitment available during the previous quarter multiplied by a percentage which varied based on the Taxpayer's credit rating during that quarterly period. For purposes of this computation, the total commitment did not increase or decrease based on the amount of credit utilized by the taxpayer. Thus, the amount of each facility fee was not tied to the use of credit under the Agreement. Under these facts, each facility fee appears more closely allocable to the three-month period preceding the payment of the fee than to any asset having a useful life substantially beyond the taxable year. The mere fact that non-payment of a facility fee would have resulted in a default under the Agreement, and could ultimately cause a termination of the Agreement, does not establish that the fee is a cost of creating or enhancing a separate long-term asset. Accordingly, as imposed, each facility fee did not serve to create or enhance a separate asset, but rather kept the Agreement in place (and as a result, kept its terms available) for a period not extending substantially beyond the taxpayer's taxable year.

For similar reasons, the facility fees also did not produce significant future benefits for the Taxpayer. As discussed above, each facility fee was imposed in arrears on a quarterly basis, and related only to the quarter on which it was based. Thus, each facility fee compensated the counterparty only for the benefits enjoyed by the Taxpayer during the three-month period prior to the date that the payment was due under the Agreement. In addition, the Agreement provided no indication that the payment of each facility fee generated any significant future benefits to the Taxpayer. Rather, the Taxpayer was required to pay another facility fee in each succeeding quarter to keep the Agreement in place for the quarter to which the payment related. Accordingly, the facility fees did not produce any significant future benefits that would require capitalization under § 263.

In addition, the facility fees in the present case are unlike the costs incurred in cases involving certain prepaid expenses, origination costs, and acquisition costs that must be capitalized under § 263. In those cases, taxpayers typically prepaid expenses to obtain rights, benefits, or economic interests that extended substantially beyond the taxable year in which such payment was made. See, e.g., Seligman v. Commissioner, 796 F.2d 116 (5th Cir. 1986) (payments made by lessors during the first 12 months of 41-month lease for administrative services to be performed during the entire lease period had to be capitalized and amortized over the life of the lease); Commissioner v. Boylston Market Ass'n, 131 F.2d 966 (1st Cir. 1942) (prepaid insurance premiums on policies running longer than a single taxable year could not be deducted wholly in year in which they were paid, but should have been deducted pro rata for each one of tax years covered by such policies); Main & McKinney Bldg. Co., of Houston, Tex. v. Commissioner, 113 F.2d 81 (5th Cir. 1940) (advance payments of rent, made in consideration of a lease for a longer period of time, had the character of capital investments whose benefits should be spread throughout the life of the lease); Lovejoy v. Commissioner, 18 B.T.A. 1179 (1930) (commissions, fees, and printing costs paid in one year by a taxpayer in securing a loan for 10 or 15 years were not deductible in full in the year of payment). The reasoning underlying these cases is that the costs incurred in an earlier year resulted in the acquisition of a future right, benefit, or interest that extended beyond the year in which the costs were paid or incurred. As a result, the costs were not deductible immediately, but were required to be capitalized and ratably recovered over the life of the right, benefit, or interest. See, e.g., Lovejoy, 18 B.T.A. at 1182.

In the present case, the facility fees at issue were not prepaid or incurred in one taxable year to obtain a benefit that continued throughout the entire Agreement. Rather, the facility fees were paid in arrears following the end of each quarter during the term of the Agreement. Under this Agreement, each facility fee related only to the period preceding the payment and did not secure for the Taxpayer any new benefits, rights, or interests that extended beyond the taxable year. Thus, these facility fees are not analogous to prepaid expenses that benefit future periods, and are not required to be capitalized under § 263.

II. Whether Rev. Rul. 81-160 Applies to the Taxpayer's Facility Fees

Rev. Rul. 81-160, 1981-1 C.B. 312, involved loan commitment fees incurred pursuant to a bond sale agreement under which funds for construction were made available in stated amounts over a specified period. The commitment fees addressed in the ruling were calculated at a specified percent per annum based on the principal amount of the unissued bonds. The commitment fees were paid by the taxpayer for the purpose of having money made available when needed to preserve a firm price for, and interest rate on, the total bond issue. The ruling stated that a loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. If the right is not exercised, the taxpayer may be entitled to a loss deduction under § 165 when the right expires.

Based on the facts of this case, we conclude that the payments in this case are not in the nature of the standby charges discussed in Rev. Rul. 81-160. Accordingly, Rev. Rul. 81-160 on its face does not apply to this case.

III. Whether the Facility Fees Were Deductible in the Year that They Were Paid

Section 461(a) provides generally that the amount of any deduction shall be taken for the taxable year which is the proper year under the method of accounting used in computing taxable income.

Section 461(h) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

Section 1.461-1(a)(2) provides, in part, that under an accrual method of accounting, a liability is incurred, and generally is taken into account, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 1.461-4(g)(7) provides that in the case of a taxpayer's liability for which specific economic performance rules are not provided elsewhere in this section or in any other regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed.

Pursuant to the terms of the Agreement, the Taxpayer paid facility fees in Year 2 on the first business day of each calendar quarter in arrears for the previous quarter. Because neither the statutory nor regulatory rules provide for an earlier time when economic performance occurs with respect to the Taxpayer's liability for facility fees imposed under a revolving credit agreement, economic performance occurred under § 1.461-4(g)(7) as the Taxpayer made payment to the lenders. By that time, all the events had occurred which established the fact of the liability and the amount of the liability could be determined with reasonable accuracy. See § 1.461-1(a)(2). Thus, on the facts of this case, the Taxpayer incurred, and could take into account, the liability for the facility fees in the taxable year in which the facility fees were paid.

Based upon the facts as submitted and the above discussion, we conclude that these facility fees were not in the nature of capital expenditures under § 263.

Specifically, the payment of these fees did not create or enhance a separate and distinct asset with a useful life extending substantially beyond the taxable year, nor did they generate significant future benefits for the Taxpayer. Moreover, these facility fees are not described in Rev. Rul. 81-160. Rather, the facility fees were properly characterized as ordinary and necessary business expenses deductible under §162. Accordingly, the Taxpayer was entitled to deduct the facility fees in the taxable year incurred under § 461, which was the taxable year in which they were paid by the taxpayer.

CAVEAT:

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.