INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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July 29, 2002

Taxpayer's Name:

Taxpayer's Address:

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

LEGEND:

Taxpayer =
Y Corp =
$x =
Year A =

ISSUE:

Whether Taxpayer's transfer of $x to two of its structured securities mutual funds in Year A is deductible under section 162 of the Code or whether such payments resulted in significant long term benefits requiring the entire amount to be capitalized pursuant to § 263.

CONCLUSION:

Taxpayer's transfer of $x to two of its structured securities mutual funds primarily protected, maintained, and preserved its business and did not provide significant long term benefits; thus, the payments of $x is deductible under § 162 in Year A.

FACTS:
Taxpayer is a large commercial bank and financial institution. In Year A, Taxpayer was the investment advisor to nearly a dozen proprietary mutual funds. Most of the proprietary mutual funds had been set up by a competitor of Taxpayer, who was merged into the Taxpayer a few years prior to Year A. In all of proprietary funds,

Taxpayer did not own any of the shares of the fund. Taxpayer did, however, earn an investment advisor fee based on the amount of assets in each fund.

Two of Taxpayer's largest funds, with investments in U.S. government agency structured securities, ran into significant difficulties in Year A, due to rises in interest rates during that year. Based on the interest rate rises, these structured securities mutual funds saw their rate of return become significantly less competitive. As a result, investors redeemed their shares in droves, requiring sale of fund assets at a loss to meet the heavy rate of redemptions, resulting in a significantly reduced net asset value for both funds. Over a two month period, the net asset value of each of the two structured securities mutual funds approached par value, $1.00 per share.

In Year A, Taxpayer was not aware of any money market mutual fund where a net asset value had "broken a dollar" (having a net asset value less than $1.00 per share). Taxpayer was under no legal obligation to bail out the funds. Taxpayer was aware, however, that the Security and Exchange Commission (SEC) rules, which governed these mutual funds, required an investment company to take action to eliminate any deviation between the net asset value and $1.00 per share, if the net asset value fell below $0.996 per share (usually by a re-valuation of the fund, wherein a shareholder would hold fewer shares). At the end of April in Year A, Taxpayer's two structured securities mutual funds were perilously close to "breaking a dollar" and close to running afoul of the SEC rules.

Taxpayer saw three courses of action. First, it could do nothing, thus allowing these two funds to "break a dollar." In such a case, the funds would have to re-value their shareholders' shares to conform with the reduced total fund assets, and notify the shareholders that they now held fewer fund shares than before. Taxpayer believed this would have a negative impact on its future mutual fund business and other security related businesses. Further, although Taxpayer had no legal obligation to bail out these funds, it was nevertheless concerned about possible lawsuits by fund shareholders if the funds did "break a dollar."

Taxpayer's second option was to purchase fund assets "at par" and hold them to maturity. This was apparently rejected immediately, because the purchase price exceeded readily available funds, would be hard to keep out of the press, and would subject Taxpayer to even bigger losses if interest rates continued to rise, all of which could result in shareholder suits by Taxpayer's own shareholders.

Third, Taxpayer could bail out the funds by simply transferring monies to the two structured securities mutual funds in the amount of the losses suffered by the funds. Taxpayer chose this option. During May, June, and July of Year A, Taxpayer transferred a total of $x to these two funds.

Taxpayer received no shares or other ownership interest in exchange for the $x. Taxpayer deducted the transfers on its return for Year A. The mutual funds treated the transfers as capital gains, offsetting realized losses to raise the funds' net asset values.

An internal memorandum of Taxpayer, written in Year A, provides this reasoning for the contribution of $x:

> This is to document the reimbursement on [date in Year A] of a Capital Loss by the [structured securities] Mutual funds. The attached contribution is to avoid damage to the Company's goodwill and reputation and to avoid potential mutual fund shareholder litigation and/or shareholder redemptions.

Another internal memorandum, again written contemporaneously in Year A for the Board of Directors, explained the reasons for these "contributions" in greater detail:

> The decision to make the cash capital contributions to support and build the funds, as proprietary mutual funds, was made in part in response to the trend of the Bank's core customer base turning away from insured deposit products and turning towards uninsured non-deposit investment products, like mutual funds over the last several years. More importantly, sales of proprietary mutual funds helps the Bank defend its core retail franchise. Furthermore, Taxpayer's proprietary mutual funds appear to have substantial profit potential.

In summary, Taxpayer's internal memorandums describe a number of reasons for bailing out the two "M" mutual funds:

1. Avoid damage to Taxpayer's goodwill and reputation.

2. Avoid potential mutual fund shareholder suits.

3. Avoid mutual fund shareholder redemptions.

4. Support and build Taxpayer's proprietary mutual funds, which was seen as:

a) helping Taxpayer defend its core retail franchise, and

b) having substantial profit potential in its own right.

LAW AND ANALYSIS:

Section 162 of the Code and § 1.162-1(a) of the Income Tax Regulations generally allow a deduction for all the ordinary and necessary expenses paid or incurred during

the taxable year in carrying on any trade or business. Courts generally have construed § 162 as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) ordinary, (3) necessary, (4) paid or incurred during the taxable year, and (5) made to carry on a trade or business. See Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345, 352 (1971).

Section 263 prohibits a deduction for capital expenditures. Section 263(a) and § 1.263(a)-1(a) provide that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Section 161 clarifies the relationship between deductions allowable under § 162 and capital expenditures under § 263 or 263A. Section 161 provides that the deductions allowed in Part VI of the Code (which includes § 162), are subject to the exceptions set forth in Part IX (which includes § 263). Thus, the capitalization rules of § 263 take precedence over the rules for deductions under § 162, with the result that an expenditure that is otherwise an ordinary and necessary business expense under § 162 must be capitalized if it is also a capital expenditure under § 263 or § 263A. See also Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974). Furthermore, it is well-established that deductions are a matter of legislative grace and the taxpayer bears the burden of proving entitlement to the deduction sought. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992).

Through provisions such as §§ 162(a), 263(a), 263A, and related sections, the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e.g., INDOPCO v. Commissioner, 503 U.S. 79, 84 (1992); Idaho Power, 418 U.S. at 16.

Using these principles, the Supreme Court has held that taxpayers must capitalize the costs of creating or acquiring a separate and distinct asset with a useful life extending substantially beyond the end of the taxable year. Lincoln Savings and Loan, 403 U.S. at 354. Furthermore, expenditures incurred in connection with the acquisition of a capital asset are also capitalized. Commissioner v. Idaho Power Co., 418 U.S. at 17. Finally, the Supreme Court has added a third standard for capitalization, requiring expenditures to be capitalized under § 263 if they generate significant future benefits. INDOPCO, 503 U.S. at 87-88.

The INDOPCO decision clarifies that the creation or enhancement of a separate and distinct asset is not a prerequisite to capitalization. That clarification does not, however,

change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized. As the Supreme Court has specifically recognized, the "decisive distinction [between capital and ordinary expenditures] are those of degree and not of kind." Deputy v. du Pont, 308 U.S. 488, 496 (1940); Welch v. Helvering, 290 U.S. 111, 114 (1933); see also INDOPCO, 503 U.S. at 87. Therefore, with respect to expenditures that produce benefits both in the current year and in future years, the determination of whether those expenditures must be capitalized or may be deducted requires a careful examination of all the facts.

In this situation, Taxpayer transferred $x in Year A to two of its mutual funds. The payments were for four identified reasons: (1) to avoid damage to Taxpayer's goodwill and reputation; (2) to avoid potential mutual fund shareholder suits; (3) to avoid mutual fund shareholder redemptions; and (4) to support and build Taxpayer's proprietary mutual funds, which helped Taxpayer defend its core retail franchise (banking) and provided substantial profit potential in its own right (from advisory fees). Taxpayer's payments did not result in any ownership interest in the funds, nor did the Taxpayer receive any additional remuneration in exchange for the payments. The Taxpayer did continue, however, to earn fees as the advisor to the mutual funds. Accordingly, Taxpayer's payments did not create a separate or distinct asset, nor were the payments incurred in connection with the acquisition of a capital asset (the mutual funds were already operating). The sole basis for capitalization of the $x is that such payment transfers provided significant long term benefits under INDOPCO.

We do not believe that the payments made by Taxpayer in Year A provided Taxpayer with significant long term benefits such that capitalization is required. Generally, expenditures made to protect or promote a taxpayer's business and which do not result in the acquisition of a separate and distinct asset are deductible under § 162 as ordinary and necessary business expenses. See Van Iderstine Co. v. Commissioner, 261 F.2d 211 (2nd Cir. 1958) (payments made to suppliers to ensure a continuing supply of raw materials were deductible); T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581 (1993) (expenses incurred to protect, maintain, or preserve a taxpayer's business generally do not result in significant future benefits); Snow v. Commissioner, 31 T.C. 585 (1958), acq., 1959-2 C.B. 7 (payments made to protect and supplement the taxpayer's income from its existing law business were deductible).

> It is well established that expenses incurred to protect, maintain, or preserve a taxpayer's business, even though not in the normal course of such business, may be deductible as ordinary and necessary business expenses. Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729, 742 (1977); see United States v. E.L. Bruce Co., 180 F.2d 846 (6th Cir. 1950); L. Heller & Son, Inc. v. Commissioner, 12 T.C. 1109 (1949); Catholic News Publishing Co. v. Commissioner, 10 T.C. 73 (1948); Miller v. Commissioner, 37 B.T.A. 830, 832-833 (1938).

T.J. Enterprises, 101 T.C. at 589 (footnote omitted). Payments made to protect goodwill, to prevent lawsuits, to prevent redemptions, and to protect the core business of a taxpayer would all seem to fall within the category of payments which are made to protect and preserve a taxpayer's business. Such analysis applies even though the protection of the Taxpayer's business and reputation, along with the protection of its future income stream (from the mutual fund fees) did produce long term benefits. Furthermore, this analysis applies even though the transfer of $x was not made in the normal course of Taxpayer's business, because of the unusual situation of the structured securities mutual funds and the interest rate increases in Year A. Regardless, the transfer payments were primarily made to protect the reputation of Taxpayer, to prevent assault on the Taxpayer's business by either litigation or loss of customers, and to preserve the reputation of Taxpayer as a mutual fund advisor and overall quality financial institution. As such, the payments made by Taxpayer are deductible under § 162 as ordinary and necessary business expenditures in Year A.

Capitalization is not required for every expenditure that produces some future benefit. For example, the costs of training, including the costs of trainers and routine updates of training materials, are generally deductible as business expenses under § 162, even though they may have some future benefit. See, e.g., Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985) (deduction for costs of training employees to operate new equipment in an existing business); Rev. Rul. 96-62, 1996-2 C.B. 9 (INDOPCO decision does not affect the treatment of training costs as business expenses, which are generally deductible under § 162). Likewise, § 263(a) requires an examination of not only the duration of the benefits, but also the significance of the benefits. See INDOPCO, 503 U.S. at 87 (the mere presence of an incidental future benefit may not warrant capitalization). See also Rev. Rul. 96-62 (training costs generally are deductible under § 162 even though they may have some future benefit); Rev. Rul. 94-12, 1994-1 C.B. 36 (incidental repair costs generally are deductible under § 162 even though they may have some future benefit); Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising costs generally are deductible under § 162 even though they may have some future effect on business activities).

Service position is that expenditures made primarily to protect or preserve an established business are currently deductible, even if a secondary result of such expenditures for protection and preservation result in long term benefits.

> Although it has been held that expenditures made to acquire or promote a new business may not be deducted as ordinary and necessary business expenses ..., it is well settled that expenditures made by a taxpayer to retain or protect and promote an established business may be deducted as ordinary and necessary expenses.

Rev. Rul. 56-359, 1956-2 C.B. 115, 116 (citations omitted)). See also Rev. Rul. 79-283, 1979-2 C.B. 80 (payments made by a member of a savings and loan association

league to a disaster fund for victims of natural disasters who have property mortgaged with the members of the league are deductible because the payments were made to prevent injury to the taxpayer's business); Rev. Rul. 78-389, 1987-2 C.B. 125 (legal expenses incurred to invalidate a municipal ordinance that prohibited operation of taxpayer's business are deductible); Rev. Rul. 76-203, 1976-1 C.B. 45 (storage company's payments made to uninsured customers for losses sustained when fire destroyed the company's warehouse are deductible because the were made to preserve the company's goodwill among its customers and protect its business reputation); Rev. Rul. 73-226, 1973-1 C.B. 62 (corporation's payments to depositors and creditors of its insolvent foreign subsidiary bank to protect the corporation's reputation and goodwill are deductible).

Taxpayer's transfer of $x to two of its structured securities mutual funds primarily protected, maintained, and preserved its business. Such payments only secondarily provided long term benefits, which benefits were not significant in quality or duration within the meaning of INDOPCO. Accordingly, the payments of $x are deductible under § 162 in Year A.

CAVEAT(S)

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