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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR RICHARD A. WITKOWSKI
DISTRICT COUNSEL CC:MSR:ILD:CHI

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: INQUIRY ON DEDUCTIBILITY OF EXIT AND ENTRANCE FEES

This Field Service Advice responds to your memorandum dated August 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer:
Bank:
S&L:
Year 1:
Year 2:
Year 3:
Year 4:
Year 5:
Year 6:

ISSUE(S):

1. Whether exit and entrance fees incurred by Taxpayer on account of its transfer of insured deposits from the Savings Association Insurance Fund to the Banking Insurance Fund should be treated as ordinary and necessary business expenses or capital expenditures during the years at issue.

2. If the fees are capital expenditures, whether they are subject to an allowance for depreciation.

CONCLUSION:

1. The exit and entrance fees incurred by Taxpayer on account of its transfer of insured deposits from the Savings Association Insurance Fund to the Banking Insurance Fund fees were paid as part of a plan to produce a positive business benefit for future years. As such, they should be treated as capital expenditures.

2. The cost of the exit and entrance fees are not subject to a depreciation allowance under section 167 because the benefits under BIF do not have a limited life. The right to insurance or membership in BIF attaches to a constant percentage of deposits, not to the life of the specific deposits acquired; thus, the benefits are not depleted due to time or use and are not subject to depreciation. However, the exit and entrance fees may be subject to an allowance for amortization under section 197 depending on the acquisition date of the intangible.

FACTS:

We rely on the facts set forth in your memorandum.

Taxpayer is a bank holding company that owns all of the outstanding stock of Bank. Taxpayer and its subsidiaries, including Bank, filed consolidated returns for the years at issue. Taxpayer uses an accrual method of accounting for federal income tax purposes.

In October of Year 1, Bank acquired the assets and assumed the liabilities of S&L. Prior to the acquisition, S&L was a member of the Savings Association Insurance Fund (SAIF). SAIF is a fund administered by the Federal Deposit Insurance Corporation (FDIC) that provides insurance to financial institutions for time and demand deposits. At the time of the acquisition, Bank was a member of the Banking Insurance Fund (BIF). BIF is also a fund administered by the FDIC. Like SAIF, BIF provides insurance to financial institutions on their customer deposits.

After the acquisition, Taxpayer wanted to convert S&L to BIF. To do this, Taxpayer was required to pay an exit fee to SAIF and an entrance fee to BIF in amounts based on the total amount of transferred deposits. The exit and entrance fees were imposed by section 206(a)(7) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), P.L. 101-73, 103 Stat. 183. The statute requires each insured depository institution participating in a conversion transaction to pay both exit and entrance fees. The definition of “conversion transaction” in the statute contemplates a change in status from one fund to the other and imposes the fees in order to prevent dilution of the depository insurance fund from which, and to which, the institution is transferring insured deposits.

Taxpayer paid the fees over a five-year period and deducted the amounts as insurance expense on its income tax returns for Year 2 through Year 6, inclusive. For financial reporting purposes, Taxpayer capitalized the fees and amortized them over a 10-year period.

The statutory notice of deficiency, covering Year 4 through Year 6, disallowed the deductions based on a determination that the fees were nondeductible capital expenditures not subject to depreciation or amortization.

LAW AND ANALYSIS

Issue 1

I.R.C. § 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

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 or estate.

Treas. Reg. § 1.263(a)-1 provides that no deduction shall be allowed for amounts paid or incurred to add to the value, or substantially prolong the useful life, of property owned by the taxpayer.

The determination of whether an expenditure is capital or ordinary must be based on a careful examination of the particular facts and circumstances of each case. Deputy v. Du Pont, 308 U.S. 488, 496 (1940). Pursuant to section 161, if a cost is a capital expenditure, the capitalization rules of section 263 take precedence over the deduction rules of section 162. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974). Thus, a capital expenditure may not be deducted under section 162 regardless of whether it is ordinary and necessary in the taxpayer's trade or business.

In determining whether the appropriate tax treatment of a cost is as a capital expenditure or as an ordinary expense, the Supreme Court has indicated that a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is an important factor. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87-88 (1992). While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item. Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984). Costs incurred in creating or acquiring a separate and distinct asset with a useful life that extends substantially beyond one year must be capitalized. Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971).

As you have noted, the issue of whether exit and entrance fees paid under section 206(d)(2)(E) of FIRREA are capital expenditures was the subject of two private letter rulings, Priv. Ltr. Rul. 94-02-006 (Sept. 24, 1994) and Priv. Ltr. Rul. 93-48-003 (Aug. 30, 1993). The letter rulings conclude that both fees should be capitalized.

Because a conversion transaction always results in the assessment by the FDIC of both an exit and an entrance fee, it was determined that the two fees should be analyzed as one cost. Priv. Ltr. Rul. 93-48-003 (Aug. 30, 1993). The cost was analogized to costs incurred by a lessor in canceling an old lease for the purpose of entering into a new lease. In these cases, payments by the lessor to secure the release of property from an old lease are aggregated with the costs of entering into a new lease for purposes of determining what amount should be capitalized. The Service concluded that the exit and entrance fees were similar to these cancellation costs and that they should be aggregated for purposes of determining what amount, if any, should be capitalized.

Having concluded that the exit and entrance fees should be aggregated, consideration was given to the type and duration of benefits acquired from payment of the fees. The rulings reasoned that payment of the fees allowed the taxpayers to obtain the benefits of a separate and identifiable membership in BIF for future years for the newly acquired deposits and for the future deposits of the acquired entities. Harman v. Commissioner, 72 T.C. 362 (1979). Accordingly, the benefits were deemed capital in nature.

We believe the rationale of these rulings applies in this case, which is factually indistinguishable. Payment of both fees is required to transfer insured deposits from one depository insurance fund to the other. The payments are assessed in the same administrative process under the control of the FDIC. Under these circumstances, it is reasonable to treat the fees as one cost. Further, because the fees are incurred as part of an overall plan to obtain depository insurance in another fund and result in long-term benefits, they are distinguishable from annual premium costs, or other currently deductible expenses.

In Darlington-Hartsville, the taxpayers were bottling companies. For many years they were required to buy Coca-Cola syrup from a middleman who had exclusive rights to bottle the syrup in specified areas of South Carolina. In an effort to eliminate the middleman and acquire the right to purchase the syrup directly from Coca-Cola, the taxpayers entered into negotiations with Coca-Cola. In the end, Coca-Cola agreed to buy the middleman out and liquidate the corporation. The taxpayers reimbursed Coca-Cola for the costs of the stock acquisition and in exchange were awarded contracts to purchase the syrup directly from Coca-Cola. Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494 (4th Cir. 1968).

The taxpayers deducted the payments to Coca-Cola, arguing they were made to eliminate burdensome and onerous contracts and were, therefore, ordinary and necessary business expenses. The Service argued the payments were for the purpose of acquiring new and more favorable bottling contracts and, thus, were capital expenditures. Relying on the principle that an expenditure is a capital outlay if it brings about the acquisition of a business advantage extending into the indefinite future, the district court reasoned that the payments were part of a plan to improve the future profits of the taxpayers by eliminating a non-productive middleman and by reducing the base prices paid for syrup. Darlington-Hartsville, 273 F. Supp. at 231. The court concluded that the taxpayer could not deduct as a current business expense the full cost of acquiring an asset, tangible or intangible, which benefitted the taxpayer for more than one year. Id. The Fourth Circuit agreed, indicating that a capital expenditure is distinguished from a current expense by its intendment to produce a positive business benefit whose effect will be reaped in seasons beyond a single year. Darlington-Hartsville, 393 F.2d at 496. Because the payments were designed to procure a less costly syrup and better the taxpayers' profits over future years, the court concluded the payments were a capital investment. Id.

In Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974), the taxpayer was in the business of operating a chain of motels. To further develop the chain of motels, the taxpayer entered into territorial agreements in which it granted exclusive rights to construct Rodeway motels within a certain geographic area. The particular agreement that was at issue in the case covered a period of two years, but could be extended at 2-year intervals until 1994. The agreement could not be canceled by the taxpayer unless the other party failed to perform in accordance with the contract terms.

By 1968, the taxpayer had determined it could develop the territory covered by the agreement more effectively on its own. It was concerned that the territory was not being developed as rapidly as necessary for the taxpayer to maintain its competitive position in the industry. The taxpayer believed that canceling the agreement would enhance the value of its motels and yield greater profits in the long run. Accordingly, in August of 1968 the taxpayer paid $100,000 to terminate the territorial agreement. The taxpayer deducted the payment as a business expense on its 1968 return. The Service disallowed the deduction on the grounds that the payment was a capital expenditure.

The Tax Court agreed with the Service that the payment was a capital expenditure. The court likened the situation to one in which a payment is made to acquire a new business. Because the payment was made to enhance the taxpayer's business opportunities in the Southwest area and to provide the opportunity for increased income, it was capital in nature. Id. at 419. The court rejected the taxpayer's argument that the payment was made to secure release from a burdensome

contract. Instead the court found that the payment was a capital expenditure since it was made to acquire the right to conduct a business from which the taxpayer could anticipate earning profits over future years.

We believe the instant situation bears a resemblance to Darlington-Hartsville and Rodeway Inns. The fees were paid to as part of a plan to produce a positive business benefit for future years. As such, they should be characterized as capital expenditures.

You have asked whether the result is affected by the enactment of the Deposit Insurance Funds Act of 1996 (DIFA). Section 2702 of DIFA provides for a special assessment on all SAIF-assessable deposits. Under the express terms of the statute, the assessment is deductible under section 162 of the Code.

The enactment of DIFA does not affect our conclusion on the treatment of exit and entrance fees. In the first place, the statute was enacted well after FIRREA and does not specifically cover exit and entrance fees. In the second place, the assessment under DIFA differs from the imposition of exit and entrance fees under FIRREA in several material respects. The assessment under DIFA was a one-time payment that was required for holders of SAIF-assessable deposits. An institution with eligible deposits had no choice but to pay the assessment. In addition, payment of the assessment did not automatically result in a switch from one fund to the other and did not entitle the payor to something new. It was simply an assessment to raise SAIF funding to sufficient levels for current needs. Therefore, it was reasonable to conclude the assessment was currently deductible.

By contrast, payment of the exit and entrance fees under FIRREA was completely discretionary. Financial institutions could avoid the fees completely by leaving their deposits with the former fund. In addition, contrary to Taxpayer's argument, the exit and entrance fees were not necessarily a one-time charge. If a financial institution engaged in more than one conversion transaction, it presumably would have to pay exit and entrance fees on all such transactions. Moreover, as we have discussed, payment of the fees produced significant long-term benefits that extended well beyond one tax year, including benefits associated with the consolidation of the institution's depository insurance under one fund and the benefit of reduced expenses. Under these circumstances, we agree with your conclusion that there are sufficient distinctions in the two statutes to warrant different tax treatment for payments made under each.

We are unpersuaded by Taxpayer's argument that the fact that DIFA contains an express provision allowing a current deduction under section 162 supports the argument that Congress intended the exit and entrance fees under the FIRREA to be currently deductible. To the contrary, the provision suggests that Congress felt compelled to clarify the tax treatment for the assessment and distinguish it from the

treatment of the exit and entrance fees. Congress was certainly aware of the Service's position on exit and entrance fees at the time DIFA was enacted, as evidenced by the briefing materials prepared by the Joint Committee on Taxation. See Joint Committee on Taxation, Discussion Relating to the Tax Treatment of Thrift Institutions Under H.R. 2494, the "Thrift Charter Conversion Tax Act of 1995", (JCX–95), October 1995. Thus, if Congress disagreed with the Service's position on exit and entrance fees, it was in a position to address the treatment of the fees directly, rather than indirectly through a marginally related provision.

Issue 2

Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business.

Treas. Reg. § 1.167(a)-3 addresses the depreciation of an intangible asset and provides in part:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. . . . An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation.

In this case, Taxpayer, through Bank, transferred the newly acquired deposit accounts from SAIF to BIF. In order to do so, Taxpayer paid the exit and entrance fees over a five-year period. As a result of the payment of the exit and entrance fees, the transferred deposits and a portion of Bank's future deposits were eligible for depository insurance under BIF for future years. Moreover, all of Bank's deposits were insured through one insurance fund and subject to only one set of regulations. This resulted in long-term benefits to Taxpayer that constitute an intangible capital asset. The costs incurred in creating this intangible asset should be added to any other costs incurred in obtaining membership in the BIF program and added to the basis.

Although the benefits of Bank's membership in the BIF program constitute an intangible asset, they are not depleted due to time or use. The benefits will continue indefinitely for as long as membership is retained. Because the membership has no ascertainable life the cost basis of the membership, which includes the exit and entrance fees paid, it is not depreciable under section 167.

Section 197 provides for the amortization of goodwill and certain other tangibles and was enacted on August 10, 1993. Section 197(a) provides that a taxpayer is

entitled to an amortization deduction for any amortizable section 197 intangible. The amortization is ratable over a 15-year period.

An amortizable section 197 intangible means any section 197 intangible acquired by the taxpayer after the date of the enactment of section 197 which is held in connection with the conduct of a trade or business or an activity described in section 212. I.R.C. § 197(c)(1).

In this case, it is unclear when the intangible in question was acquired because the exit and entrance fees were paid over a five-year period. However, both the acquisition of the deposits and the first payment of exit and entrance fees occurred prior to the effective date of section 197. Assuming it is determined that the intangible was acquired in Year 1, the intangible would not qualify as an amortizable section 197 intangible because it was not acquired after August 10, 1993.[1]

Under this scenario, Taxpayer would not be entitled to deductions for depreciation under section 167 or amortization under section 197 and the costs incurred in transferring the deposit accounts from SAIF to BIF could not be recovered until such time as the Bank's membership in the BIF program were terminated or upon the sale or other disposition of all of Bank's assets.

If it is determined that the intangible was acquired after August 10, 1993, Taxpayer would be entitled to amortize the intangible ratably over a 15-year period if the intangible qualifies as a "section 197 intangible" under section 197(d). As provided in section 197(d)(1)(C)(v), a section 197 intangible includes "any supplier-based intangible." A supplier-based intangible is defined as "any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer." I.R.C. § 197(d)(3). Membership in the BIF program appears to fall into this category and, thus, would qualify as a section 197 intangible. If acquired after August 10, 1993, the intangible would be amortized ratably over a 15-year period from the date of acquisition.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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[1]If the intangible was acquired after July 25, 1991, Bank could elect to have the provisions of section 197 apply to the acquisition of the membership in the BIF program. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13261(g)(2)-(3), 107 Stat. 312. If an election is made under this section, the date of the enactment of section 197 is treated as July 25, 1991, which allows otherwise nonamortizable section 197 intangibles to be amortized.

Issue 1

Issue 2

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