Office of Chief Counsel
Internal Revenue Service
memorandum

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from: Sean Dwyer
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subject:

This Chief Counsel Advice responds to your request for assistance on whether construction support payments made by Taxpayer to its retailers are required to be capitalized by § 1.263-4 of the Income Tax Regulations. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Agreement =

$x =

Facility =

Z =

Slogan =

ISSUES

Whether construction support payments made by Taxpayer to its retailers are required to be capitalized by § 1.263-4.

CONCLUSIONS

The construction support payments made by Taxpayer to its retailers are not required to be capitalized by § 1.263(a)-4.

FACTS

Taxpayer produces Z products and distributes through a network of dedicated retailers. Taxpayer has a standing offer for its retailers to enter an Agreement to maintain its retail space as a Facility that conforms to Taxpayer's design requirements. The Agreement provides that Taxpayer will provide $x of construction support payments to retailers of Z products, with a percentage paid upon groundbreaking or commencement of renovation construction and a percentage paid upon commencement of operation of a Facility for Z products. The agreement provides that repayment of all the construction support payments to Taxpayer will be required immediately if within 15 years of commencing operations as a Facility the retailer, seeks Taxpayer's approval to no longer conform to the requirements of a Facility or no longer sells and maintains a full line of Z products and/or no longer provides servicing at the Facility.

The retailer is required to incorporate seven critical image elements, including:

(1) An elevated glass display several feet off the ground.

(2) An area with information and brochures.

(3) A display platform 1' to 2' off the ground.

(4) An area with a coffee machine and doughnuts.

(5) A greeter station with a computer.

(6) Key colors and materials.

(7) Key signage - Z signage and Slogan signage –Depending on the location of the retailer, this could include signs in the building, on the building and/or on posts.

It is our understanding that the agreement does not obligate the retailer to purchase any specific quantity of Z products, and does not confer with any right other than the right to require the retailer to conform its premises to the Facility design.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code provides a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) provides that deductible business expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. 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 Company, 418 U.S. 1 (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 263(a) provides generally 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.

In Indopco, Inc. v. Commissioner, 503 U.S. 79, 86 (1991), the Court established the test for capitalization as being whether an expense results in a significant future benefit. Currently, the capitalization of intangibles is governed by §§ 1.263(a)-4 and 1.263(a)-5 which define the exclusive scope of the significant future benefit test, generally by providing specific categories of intangible assets for which capitalization is required.

Section 1.263(a)-4 provides rules for applying § 263 to amounts paid to acquire or create intangibles. Section 1.263(a)-4(b)(1) provides that except as otherwise provided in § 1.263(a)-4, 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 the Internal Revenue Bulletin as an intangible for which capitalization is required; and (v) facilitate (as defined in § 1.263(a)-4(e)(1)) the acquisition or creation of an intangible.

In general, advertising and marketing expenses are deductible because they do not fall within a category required to be capitalized by § 1.263(a)-4. Even before the release of § 1.263(a)-4 in 2003, the future benefit from advertising was generally considered to be too ephemeral to be a “significant future benefit”. See, Rev. Rul. 92-80; 1992-2 C.B. 57.

Although the Taxpayer’s construction support payments does not confer Taxpayer with any interest in tangible property, it does create an intangible right to require the retailers to conform to the Agreement’s Facility design concepts. We conclude that the construction support payments do not create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3), because Taxpayer’s rights have no value apart from the promotion of Taxpayer’s Z product line. Therefore we examined whether the created intangible was required to be capitalized by § 1.263(a)-4(d)(2) as creating a financial interest, § 1.263(a)-4(d)(6) as creating a contract right that is required to capitalized, or § 1.263(a)-4(d)(8) as an improvement to real property owned by another that can reasonably be expected to produce significant economic

benefits for the taxpayer. No other category of expenditure described in § 1.263(a)-4 is relevant.

1.263(a)-4(d)(2) - Financial interests

Section 1.263(a)-4(d)(2)(i) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the financial interests enumerated in § 1.263(a)-4(d)(2)(i). Section 1.263(a)-4(d)(2)(i) generally provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of certain financial interests. The construction support payments in this case do not involve any of the items described in § 1.263(a)-4(d)(2)(i) except, possibly, forward contracts or options described in § 1.263(a)-4(d)(2)(i)(C)(6) & (7).

An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate a financial interest with that party if the payment: (1) is made with the mere hope or expectation of developing or maintaining a business relationship with that party and (2) is not contingent on the origination, renewal, or renegotiation of a financial interest with that party. Section 1.263(a)-4(d)(2)(ii).

In this case, the retailers are required to sell and maintain a full line of Z products and provide servicing at the Facility. However, the retailers are not required to purchase any specific amount of products from Taxpayer during the term of the agreement, and the price of the product is not fixed at the time of the agreement. Taxpayer does not have the right to provide any specific quantity of products to the retailers. Under these circumstances, the agreement does not constitute a forward contract or option. Accordingly, these amounts are not paid to create an intangible described in § 1.263(a)-4(d)(2).

1.263(a)-4(d)(6) - Contract rights

Section 1.263(a)-4(d)(6) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party certain enumerated agreements or covenants. These agreements include an agreement providing the taxpayer: (1) the right to provide or to receive services or (2) the right to be compensated for services regardless of whether the taxpayer provides such services. Section 1.263(a)-4(d)(6)(i)(B). However, an agreement does not provide the taxpayer a right to provide services if the agreement merely provides that the taxpayer will stand ready to provide services if requested, but places no obligation on another person to request or pay for the taxpayer's services. Section 1.263(a)-4(d)(6)(iv).

The agreement provides that the retailers shall sell a full line Z products and provide servicing for Z products but does not obligate the retailer to purchase any specific quantity of products or services from Taxpayer. Accordingly, these amounts are not paid to create an intangible described in § 1.263(a)-4(d)(6).

1.263(a)-4(d)(8)- Real property

Section 1.263(a)-4(d)(8) provides that a taxpayer must capitalize amounts paid for real property if the taxpayer transfers ownership of the real property to another person (except to the extent the real property is sold for fair market value) and if the real property can reasonably be expected to produce significant economic benefits to the taxpayer after the transfer. A taxpayer also must capitalize amounts paid to produce or improve real property owned by another (except to the extent the taxpayer is selling services at fair market value to produce or improve the real property) if the real property can reasonably be expected to produce significant economic benefits for the taxpayer.

Real property includes property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as roads, bridges, tunnels, pavements, wharves and docks, breakwaters and sea walls, elevators, power generation and transmission facilities, and pollution control facilities. Section 1.263(a)-4(d)(8)(iii).

The seven critical image elements that are required to be incorporated do not appear to fall under the definition of real property under § 1.263(a)-4(d)(8)(iii) as they would not remain affixed for an indefinite period of time. Rather the seven critical image elements appear to support Z's marketing efforts and to standardize the appearance of Z's retailers. Some renovation may be required, and the retailers may be required to capitalize some of these costs as purchases of or improvements to tangible property. However, we do not believe that the Taxpayer's payments to support these cosmetic renovations constitute amounts paid to improve real property owned by another under § 1.263(a)-4(d)(8)(iii), since the improvements are not permanent structural changes, and the benefit Taxpayer derives is akin to the benefit provided by advertising.

Therefore, the construction support payments made by Taxpayer to its retailers are not required to be capitalized by § 1.263(a)-4.

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Please call us at (202) 622-4950 if you have any further questions.