Internal Revenue Service

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Department of the Treasury
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Third Party Communication: None
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Person To Contact:
, ID No.

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PLR-134589-14

Date:
January 26, 2015

Legend

Taxpayer =

LLC 1 =

LLC 2 =

Shareholder A =

Shareholder A Subsidiary =

Shareholder B =

Manager =

Predecessor =

Business A =

State A =

State B	=
State C	=
Bankruptcy Code	=
Bankruptcy Court	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
Date 14	=
a	=
b	=
c	=
d	=

e =

f =

g =

h =

i =

j =

Dear :

This ruling is in response to your letter dated Date 1 and subsequent correspondence requesting a letter ruling on whether Taxpayer must capitalize a termination payment under § 1.263(a)-4(d)(7) and § 1.263(a)-5 of the Income Tax Regulations.

FACTS

Prior to the Date 2 Acquisition (defined below), Shareholder A owned all of the stock of Shareholder A Subsidiary and Shareholder A Subsidiary owned all of the outstanding interests in LLC 2, a State C limited liability company treated as a corporation for Federal income tax purposes. At such time, LLC 2 wholly owned LLC 1 and the other subsidiaries conducting Business A.

On Date 3, Shareholder A and Shareholder B entered into an agreement pursuant to which Shareholder B would acquire a majority interest in the LLC 2 Group (also known as the "**Taxpayer Group**"). Effective the same date, Shareholder B caused its wholly-owned subsidiary, Predecessor, a newly-formed State A limited liability company, to purchase from Shareholder A Subsidiary all of the outstanding voting interests in LLC 2 (the "**Date 2 Acquisition**") in exchange for a and a b interest in Predecessor.

On Date 4, LLC 2 and its subsidiaries (the "**Debtors**") filed voluntary petitions with the Bankruptcy Court and entered into a pre-packaged reorganization plan (the "**Reorganization**") under the Bankruptcy Code.

Subsequently, on Date 5, Predecessor redeemed Shareholder A's indirect b ownership interest in Predecessor such that Shareholder B became the sole member of Predecessor. Later, on Date 6, Predecessor converted to a corporation pursuant to the laws of State A and changed its name to Taxpayer.

Management Services

In connection with the Date 2 Acquisition and the Reorganization, Taxpayer and an affiliate of Shareholder B, Manager, entered into the Management Services Agreement pursuant to which Manager agreed to provide certain services (the "**Monitoring Services**") on a regular basis to help Taxpayer in the governance and oversight of Business A. The Monitoring Services included, but were not necessarily limited to, the following: (i) participation of Manager officers and employees as members of the Taxpayer board of directors (the "**Taxpayer Board**") and other governing bodies; (ii) participation of Manager officers and employees in monthly meetings; (iii) other assistance to Taxpayer in connection with the development of general corporate strategy and corporate governance functions; (iv) finance and tax oversight; (v) oversight and strategic support of Taxpayer's internal and external legal services; (vi) periodic high-level managerial and operational oversight; (vii) mergers and acquisitions advice and support; (viii) facilities advice and support; (ix) sales, marketing, and customer relations advice and support; and (x) strategic human resources support.

Manager did not provide any services on behalf of the Debtors with regard to the Reorganization or any other part of the Debtors' bankruptcy proceedings outside of its associates' membership on the Taxpayer Board.

In consideration for Manager's provision of the Monitoring Services, Taxpayer agreed to pay a monitoring fee (the "**Monitoring Fee**") equal to c per month (or approximately d per year). The Management Services Agreement executed by the parties on Date 7 was scheduled to terminate on Date 8; however, according to its terms, would renew annually for an additional e term *unless* the parties agreed not to renew before the expiration of the then-current term. In addition to the Monitoring Fee and any fees paid for certain occasional services, Taxpayer agreed to reimburse Manager for all actual and reasonable out-of-pocket expenses incurred in connection with the services provided within f following the presentation of an invoice setting forth such expenses.

Following the expiration of the initial term ending on Date 8, the Management Services Agreement was renewed for g additional e terms, the last of which expired on Date 9. Prior to each renewal and throughout the relevant annual e term, the Taxpayer Group, including Taxpayer management and its advisors or employees, would review invoices and have informal discussions regarding the Monitoring Services provided. Further, during the time that the Management Services Agreement was effective, each of Taxpayer and Manager (as well as its affiliates, such as Shareholder B) was free to enter into other contracts with different service providers or companies such that the Management Services Agreement did not provide either party with an exclusive right.

Also in connection with the Date 2 Acquisition, Taxpayer and Shareholder A Subsidiary entered into a new management services agreement (the "**Shareholder A Services Agreement**"), pursuant to which Shareholder A Subsidiary would continue to provide certain management services until Date 8.

Termination of the Management Services Agreement

Based on Taxpayer's financial growth and rejuvenated business model, both Taxpayer and Manager agreed to terminate the Management Services Agreement. On Date 10, Manager and Taxpayer entered into an agreement to terminate the Management Services Agreement (the "**Termination Agreement**"). The Termination Agreement provided that upon the consummation of an underwritten (firm commitment) public offering that results in the listing or quotation of the stock of Taxpayer on one or more nationally recognized stock exchange or quotation systems, Taxpayer will pay h (the "**Termination Fee**") to Manager in consideration for all amounts owing under the Management Services Agreement. However, Manager's receipt of a payment equivalent to the Termination Fee was not dependent upon a successful public offering. In other words, even if the Termination Agreement were to have become void as of Date 11, the parties were free to continue their relationship under the Management Services Agreement or renegotiate a termination agreement and terminate the Management Services Agreement.

The parties arrived at the h figure by reviewing precedential fees from similar transactions, deriving at a i average and then multiplying that average by a j management fee which represents an adjusted annual management fee. The adjusted annual management fee of j represents the Monitoring Fee increased by the amount of additional services and time spent by Manager starting in Date 12 when the Shareholder A Services Agreement terminated.

This h amount represents in part what Taxpayer believed would have been reasonable compensation for the services provided by Manager to a financially sound corporation because Manager had agreed to receive less than the amounts it would have ordinarily charged over the course of its services to the Taxpayer Group due to the fact that the Taxpayer Group had just emerged from bankruptcy. In addition, the h amount also represents additional compensation to Manager for having successfully turned Business A into a profitable business. No part of the Termination Fee represented a payment to terminate an exclusive right for the Taxpayer Group to use, or for Manager to provide, the Monitoring Services.

Public Offering

On Date 13, Taxpayer completed an initial public offering (the "**IPO**"). The Taxpayer Group used a portion of the net proceeds from the IPO to pay the Termination Fee. However, even if the IPO had not gone forward, Taxpayer had the financial wherewithal to pay a termination fee to Manager. In determining whether or not to undertake the IPO, none of the investment bankers, Taxpayer, or Manager required that Taxpayer pay the Termination Fee as a condition to going forward with the offering (*i.e.*, Taxpayer's payment of the Termination Fee was not a prerequisite to the occurrence of the IPO).

Manager did not assist with any of the activities generally associated with undertaking a stock offering – for example, pricing, valuation, preparing roadshow decks and banker presentations, or creating assumptions and projections – or in complying with any of the necessary filing requirements attendant to listing a company's shares of stock on an exchange. Manager did not have expertise in companies engaging in initial public offerings.

REPRESENTATIONS

(a) The Termination Fee did not exceed the value of the services provided by Manager to the Taxpayer Group.

(b) Taxpayer treated the Termination Fee as an expense for financial accounting purposes.

(c) Taxpayer treated the Monitoring Fee as an expense for financial accounting purposes and for Federal income tax purposes.

(d) Taxpayer was not prohibited from entering into a contract or other arrangement with any third-party services provider (other than Manager or its affiliates) during the time the Management Services Agreement was in effect.

RULINGS REQUESTED

1. The Termination Fee is not required to be capitalized under § 1.263(a)-4(d)(7).

2. The Termination Fee is not required to be capitalized under § 1.263(a)-5.

LAW AND ANALYSIS

Section 263(a) of the Internal Revenue Code 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 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 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.

Section 1.263(a)-4(d)(1) provides a general rule that a taxpayer must capitalize amounts paid to create an intangible described in § 1.263(a)-4(d). Section 1.263(a)-4(d)(7)(i) provides that a taxpayer must capitalize amounts paid to another party to terminate certain agreements: (A) a lease of real or tangible personal property between the taxpayer (as lessor) and that party (as lessee); (B) an agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business; or (C) an agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party.

In this case, Taxpayer terminated a Management Services Agreement under which Manager agreed to provide Monitoring Services on a regular basis to assist Taxpayer with the governance and oversight of Business A. Because the Management Services Agreement did not provide either the Taxpayer Group or Manager with an exclusive right to receive or provide the Monitoring Services, the Termination Fee did not create new intangible assets under § 1.263(a)-4(d)(7)(i)(B).

Section 1.263(a)-5 provides rules for applying § 263 to amounts paid or incurred to facilitate certain transactions, including: (i) an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition); (ii) an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b) or 707(b); (iii) an acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise); (iv) a restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in section 368 and distributions of stock by the taxpayer as described in section 355); (v) a transfer described in section 351 or section 721 (whether the taxpayer is the transferor or transferee); (vi) a formation or organization of a disregarded entity; (vii) an acquisition of capital; (viii) a stock issuance; (ix) a borrowing, and (x) writing an option (each of (i) through (x), a "**Capital Transaction**").

Under Reg. § 1.263(a)-5(b), an amount is paid to "facilitate" a Capital Transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. One of the facts relevant to the determination, although not determinative, is whether the amount would (or would not) have been paid but for the transaction.

Although Taxpayer's obligation to pay the Termination Fee was in part dependent upon whether or not a public offering occurred, the Termination Fee was not paid to facilitate the IPO. The Termination Fee represents payment for prior services and additional compensation. Furthermore, payment of the Termination Fee was not a condition in order to proceed with the IPO. While a secondary benefit of the Monitoring Services may have been that the Taxpayer Group was in a better position by Date 14 to undertake the IPO as a result of certain internal management strategies that had been initiated by Manager, the Termination Fee was not remitted for services rendered in connection with undertaking the IPO. As the court ruled in *A.E. Staley Manufacturing Co. v. Commissioner*, fees associated with general activities not directly related to the capital transaction must be treated differently. 119 F.3d 482 (7th Cir. 1997), *rev'g* 105 T.C. 166 (1995). Accordingly, the Termination Fee should not be required to be capitalized under § 1.263(a)-5 as facilitative of the IPO.

CONCLUSION

Based solely on the facts and representations submitted and the relevant law and analysis as set forth above, we conclude that:

1. The Termination Fee is not required to be capitalized under § 1.263(a)-4(d)(7).

2. The Termination Fee is not required to be capitalized under § 1.263(a)-5.

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this ruling should be attached to Taxpayer's federal tax returns for the tax years affected. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the provisions of the power of attorney currently on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Lewis K Brickates
Chief, Branch 1
Office of Associate Chief Counsel
(Income Tax & Accounting)