Internal Revenue Service

Number: **201736002**
Release Date: 9/8/2017

Index Number: 263.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
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Refer Reply To:
CC:ITA:B2
PLR-101047-17

Date:
June 08, 2017

Legend

Taxpayer =

Acquirer =

Target =

Parent =

Date1 =

Date2 =

Date3 =

Support Payment =

Dear :

This letter is in reply to a private letter ruling request dated January 3, 2017, filed by Taxpayer. Taxpayer requested rulings on the federal income tax consequences of a certain payment made by Taxpayer (Support Payment).

RULINGS REQUESTED

(1) Whether the Support Payment paid by Taxpayer to the shareholders of Target is deductible by Taxpayer under § 162 of the Internal Revenue Code.

(2) Whether the Support Payment paid by Taxpayer to the shareholders of Target is required to be capitalized by Taxpayer under § 263.

FACTS

Taxpayer represents that the facts are as follows:

Taxpayer is a limited liability company that serves as an investment adviser to Acquirer. Taxpayer is an indirect subsidiary of Parent. Parent and Acquirer are separately owned and are not related under § 267(b).

Taxpayer manages Acquirer pursuant to an investment management agreement (IMA) dated Date1. Under the IMA, Acquirer agrees to pay Taxpayer: (1) a base management fee, which is an amount equal to a percentage of Acquirer's total assets; and (2) an additional fee consisting of (a) a percentage of Acquirer's net investment income (interest income, dividend income, and other fee income, minus certain operating expenses) and (b) a percentage of Acquirer's cumulative aggregate realized capital gains minus the sum of cumulative aggregate capital losses and aggregate unrealized capital depreciation. The IMA remains effective provided that its continuance is approved at least annually by (1) Acquirer's board of directors or by vote of shareholders holding a majority of the outstanding voting securities of Acquirer and (2) the vote of a majority of Acquirer's directors who are not parties to the IMA or "interested persons" as defined in Section 2(a)(19) of the Investment Company Act of 1940. The IMA may be terminated at any time upon 60 days written notice by a vote of the stockholders holding a majority of the outstanding voting securities of Acquirer, by a vote of Acquirer's directors, or by Taxpayer.

On Date2, Acquirer entered into a merger agreement to acquire Target, subject to the approval of Target's shareholders. The merger is intended to be treated as a taxable acquisition of Target's stock by Acquirer for U.S. federal income tax purposes and will result in Acquirer indirectly acquiring all of Target's assets. As a result of the merger, Taxpayer expects that its future fees under the IMA will increase because of Acquirer's increase in asset size. The merger closed on Date3 in which all of the outstanding shares of Target stock were exchanged for Acquirer's stock and cash.

In connection with the merger, in addition to payments per share from Acquirer and Target, Target's shareholders will receive a payment per share directly from Taxpayer (totaling the Support Payment). Taxpayer will receive no stock, cash, stock, or other property from Target, Acquirer, or any of their shareholders, employees, or affiliates in

consideration for providing the Support Payment to Target's shareholders. Taxpayer is transferring the Support Payment to Target's shareholders to induce them to approve the merger with Acquirer because Taxpayer expects the merger will result in earning higher fees from Acquirer under the IMA. Taxpayer represents that investment advisors commonly provide financial inducements to attract and retain investors in entities that they advise.

LAW AND ANALYSIS

Ruling Request 1:

Section 162 provides generally that taxpayers may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a) of the Income Tax Regulations. In order to be deductible under § 162, an expenditure must be (1) paid or incurred during the taxable year, (2) related to carrying on a trade or business, and (3) ordinary and necessary for the trade or business. Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345, 352 (1971).

The term "ordinary" refers to an expenditure that is normal, usual, or customary. Deputy v. du Pont, 308 U.S. 488, 495 (1940). An expenditure may be ordinary if it is commonly and frequently incurred in the type of business involved. Id. (citing Welch v. Helvering, 290 U.S. 111, 114 (1933)).

The term "necessary" means appropriate and helpful to the development of the taxpayer's business. Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (quoting Welch, 290 U.S. at 113); Commissioner v. Heininger, 320 U.S. 467, 471 (1943).

Taxpayer requests that it be allowed to deduct the Support Payment as an ordinary and necessary business expense under §162. Taxpayer represents that the Support Payment is usual in its industry as investment advisors commonly provide financial inducements for the ordinary business reason of attracting and retaining investors in entities that they advise. Thus, we conclude that the Support Payment is an ordinary expense under § 162. Further, Taxpayer made the Support Payment with the hope of financial return as the merger of Target and Acquirer will increase Acquirer's total assets, thereby increasing the investment advisory fees paid to Taxpayer. The Support Payment is appropriate and helpful to the development of Taxpayer's business, and therefore, the Support Payment is a necessary expense under § 162.

Accordingly, based solely upon the information submitted, we conclude that the Support Payment is deductible as an expense under section 162(a), subject to the capitalization rules of § 263(a).

Ruling Request 2:

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 Co., 418 U.S. 1, 17 (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) generally prohibits deductions for capital expenditures. Section 1.263(a)-4 of the Income Tax Regulations provides rules for applying § 263(a) to amounts paid to acquire or create intangibles. Section 1.263(a)-5 provides rules for applying § 263 to amounts paid that facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions.

Section 1.263(a)-4(b)(1) provides that a taxpayer must capitalize: (i) an amount paid to acquire an intangible (see § 1.263(a)-4(c)), (ii) an amount paid to create an intangible (see § 1.263(a)-4(d)), (iii) an amount paid to create or enhance a separate and distinct intangible asset (see § 1.263(a)-4(b)(3)), (iv) an amount paid to create or enhance a future benefit identified in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalization is required under this section, and (v) an amount paid to facilitate the acquisition or creation of an intangible (see § 1.263(a)-4(e)).

Section 1.263(a)-4(c)(1) provides that, in general, a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. See also § 1.263-4(b)(1)(i). Taxpayer did not pay the Support Payment to Target's shareholders to acquire any intangible from Target in a purchase or similar transaction. Taxpayer did not receive any stock, cash, stock, or other property from Target, Acquirer, or any of their shareholders, employees, or affiliates in consideration for providing the Support Payment. As a result, the Support Payment does not constitute an amount paid to acquire an intangible within the meaning of § 1.263(a)-4(c).

Section 1.263(a)-4(d)(1) provides that a taxpayer must capitalize amounts paid to create an intangible described in that paragraph. See also § 1.263(a)-4(b)(1)(ii). The Support Payment is not one of the types of created intangibles that are listed in § 1.263(a)-4(d). As relevant here, § 1.263(a)-4(d)(6)(i)(B) provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate with that party an agreement providing the taxpayer the right to provide or receive services (or the right to be compensated for services regardless of whether the taxpayer provides such services). First, by paying the Support Payment to Target, Taxpayer is not creating, originating, entering into, renewing, or renegotiating with Target any agreement providing the right to provide or receive services or the right to be compensated for services from Target. The IMA is an agreement with Acquirer, not Target, and Taxpayer is receiving nothing in return for paying the Support Payment. Second, Taxpayer made the Support Payment with the mere hope and expectation of

developing or maintaining a business relationship with Acquirer, and the Support Payment is not contingent on the origination, renewal, or renegotiation of the IMA. See § 1.263(a)-4(d)(6)(ii). Last, because the IMA may be terminated by Acquirer with 60 days notice, the IMA does not provide Taxpayer a right to use property or to provide or receive services. See § 1.263(a)-4(d)(6)(iv). Therefore, the Support Payment is not a created intangible required to be capitalized under § 1.263(a)-4(d).

Whether an amount paid creates or enhances a separate and distinct intangible is provided in § 1.263(a)-4(b)(3). See § 1.263(a)-1(b)(iii). Section 1.263(a)-4(b)(3)(i) provides that the term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. Taxpayer receives nothing in return for making the Support Payment to Target's shareholders; i.e., Taxpayer makes the Support Payment solely to motivate Target's shareholders to approve the merger with Acquirer. Taxpayer has a mere hope that its business will increase with the merger. Taxpayer has received no property interest or right that is intrinsically capable of being sold, transferred or pledged by making the Support Payment. The point is further supported by the fact that the IMA is terminable at any time by Taxpayer or Acquirer. Therefore, the Support Payment is not an amount paid to create or enhance a separate and distinct intangible asset within the meaning of § 1.263(a)-4(b)(3).

Further, the Support Payment is not made to create or enhance a future benefit identified in the Federal Register or the Internal Revenue Bulletin. Also, the Support Payment does not facilitate the acquisition or creation of an intangible because no intangible is acquired or created by the payment, as discussed above. Therefore § 1.263(a)-4(b)(1)(iv) and (v) do not apply to the Support Payment.

Section 1.263(a)-5(a) provides that a taxpayer must capitalize an amount paid to facilitate certain transactions (described in § 1.263(a)-5(a)(1)-(10)), without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction. Under the facts represented, the Support Payment is not paid to facilitate any of the transactions listed in §1.263(a)-5(a). Therefore, the Support Payment is not required to be capitalized under § 1.263(a)-5.

Accordingly, the Support Payment is not an intangible described in the regulations accompanying § 263 and is not required to be capitalized under that section.

CONCLUSIONS

(1) The Support Payment paid by Taxpayer to the shareholders of Target is deductible by Taxpayer under § 162.

(2) The Support Payment paid by Taxpayer to the shareholders of Target is not required to be capitalized by Taxpayer under § 263.

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 materials submitted in support of the request for a ruling, such material 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 Taxpayer, who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. 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 Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representative.

Sincerely,

DAVID M. CHRISTENSEN
Assistant to the Branch Chief, Branch 2
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enc: copy for section 6110 purposes

cc:

Internal Revenue Service
Attn: Director