INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-119227-20

LB:EC:SE:TT2:T1606

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer	=
Finance Company	=
Brand 1	=
Brand 2	=
Products	=
Add-On-Products and Services	=
Product Retailer	=
Brand Retailer	=
Contract	=
Agreement	=
Retailer Document	=
Retailer Program	=
Program 1	=

Program 2	=	
Program 3	=	
Other Payment 1	=	
Other Payment 2	=	
X	=	
Y	=	

ISSUE:

Whether the Program 1, Program 2, and Program 3 payments, in excess of the principal amount of the Contract, Finance Company makes in connection with purchase of Contract from Brand Retailer are capitalized costs paid to acquire an intangible asset or currently deductible expenses.

CONCLUSION:

The Program 1, Program 2, and Program 3 Payments Finance Company makes to Brand Retailer when it purchases Contract are capitalized costs paid to acquire an intangible, not currently deductible expenses.

FACTS:

Taxpayer manufactures Brand 1 and Brand 2 Products. Finance Company is a captive finance subsidiary of Taxpayer and a member of Taxpayer's consolidated return group. As part of its trade or business, Finance Company purchases Contract from independent Brand Retailer which is not a member of Taxpayer's consolidated group. Once Finance Company purchases Contract from Brand Retailer, Finance Company assumes all obligations for collecting payments on and administering Contract.

In a typical Product Retailer financing arrangement, Product Retailer and Product purchaser enter into Contract, a single contract which includes both the sales and financing agreements for Product. Product Retailer then submits the credit application information it obtained from Product purchaser to one of several standardized information platforms which compiles, with other credit information, a data file about Contract. The data file is sent to competing finance companies which bid to purchase Contract from Product Retailer. Product Retailer then selects a finance company -- in general, the one offering the greatest compensation -- to which it will sell Contract.

Agreement between Finance Company and Brand Retailer and related documents, such as Retailer Document, describe the terms and conditions of Finance Company's purchase of Contract. Under Agreement and Retailer Document, the purchase price of Contract is its principal amount. LB&I and Taxpayer agree that Taxpayer capitalizes the purchase price of Contract. Agreement also defines Finance Company's Retailer Program as the terms and conditions under which Finance Company agrees to pay compensation to Brand Retailer for purchase of Contract. Retailer Program includes Program 1 payment, as well as Other Payment 1 or Other Payment 2. Retailer Program payment is paid separately from the purchase price of Contract.

Under Program 1, if the minimum interest rate Finance Company requires to purchase Contract (“buy rate”) is equal to or greater than the interest rate Brand Retailer negotiates with Product purchaser (“retail rate”), Finance Company pays Brand Retailer Other Payment 1 based on the amount financed. If the retail rate exceeds Finance Company’s buy rate, Finance Company pays Brand Retailer the greater of Other Payment 1 or X% - Y% of the difference between the retail rate and the buy rate. Finance Company makes Program 1 payment at the end of the month in which Brand Retailer sells Contract to Finance Company. Each Program 1 payment is tracked to a specific Contract.

Under Program 2, Finance Company pays Other Payment 1 to Brand Retailer that sells a target number of Contracts to Finance Company during a specific period. Finance Company makes Program 2 payment to Brand Retailer quarterly. Each Program 2 payment is tracked to a specific Contract.

Finance Company makes Program 3 payment to Brand Retailer that finances its wholesale new Product inventory through Finance Company (“Financing Brand Retailer”). Finance Company pays Financing Brand Retailer a one-time Other Payment 1 for each Contract Financing Brand Retailer sells to Finance Company. Finance Company makes Program 3 payment to Financing Brand Retailer each month for Contract sold to Finance Company in the previous month. Each Program 3 payment is tracked to a specific Contract.

It is common in Product industry for Product manufacturers, like Taxpayer, to offer promotional below-market rate interest financing to Product purchasers to encourage Product sales. Taxpayer represents the following facts regarding its below-market interest rate program. Taxpayer authorizes Brand Retailer to enter Contract with Brand 1 purchaser and Brand 2 purchaser (collectively, “Brand Purchaser”) at below-market interest rates. Finance Company purchases Contract from Brand Retailer for the principal amount of Contract even though the fair market value of a below-market interest rate Contract may be less than the principal amount of Contract. To reimburse Finance Company for any difference between the principal amount of Contract and the fair market value of the below-market interest rate Contract, Taxpayer pays an interest rate subvention (subvention payment) to Finance Company. The subvention payment shifts the cost of the below-market interest rate program from Finance Company to Taxpayer. Taxpayer deducts subvention payment under § 162 as a sales and marketing expense.

LAW AND ANALYSIS:

Section 162(a) of the Internal Revenue Code allows a current deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a) provides, in part, 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.
In *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 112 S.Ct. 1039 (1992), the Supreme Court noted:

> The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See §§ 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a ‘complete list of nondeductible expenditures,’ *Lincoln Savings*, 403 U.S., at 358, 91 S.Ct., at 1901, § 263 serves as a general means of distinguishing capital expenditures from current expenses. See *Commissioner v. Idaho Power Co.*, 418 U.S., at 16, 94 S.Ct., at 2766.
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> *Indopco*, 503 U.S. at 84, 112 S.Ct. at 1043.

Section 1.263(a)-4 of the Income Tax Regulations provides rules requiring the capitalization of costs associated with the acquisition or creation of an intangible.

Section 1.263(a)-4(b)(1)(i) requires a taxpayer to capitalize amounts paid to acquire an intangible.

Section 1.263(a)-4(c)(1) provides that a taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Section 1.263(a)-4(c)(1)(ii) lists a debt instrument as an example of an intangible.

LB&I argues that, as described in Agreement, Financing Company agrees to make Retailer Program payments to Brand Retailer to acquire Contract. Therefore, Taxpayer must capitalize Retailer Program payments.

Taxpayer argues that the fair market value of Contract is its principal amount. Taxpayer claims that Retailer Program payment Finance Company makes to Brand Retailer is a separate payment in excess of the fair market value of Contract, deductible under § 162 as an advertising and promotional expense. To support this argument, Taxpayer maintains that Retailer Program payment solidifies the relationships between and among Taxpayer, Finance Company, Brand Retailer, and Brand Purchaser by increasing (1) Taxpayer’s sales, and future sales, of Product to Brand Purchaser; (2) Brand Retailer’s sales, and future sales, of Add-On Products and Services to Brand Purchaser; (3) the number of Contracts Branch Retailer sell to Finance Company; and (4) the number of Brand Financing Retailers who borrow from Finance Company to purchase their wholesale new Product inventory. Taxpayer’s argument that it may deduct Finance Company's Retailer Program payment is not supported by the terms of Agreement.

Agreement specifically states that Retailer Program is Finance Company's compensation to Brand Retailer for the purchase of Contract. Retailer Program payment includes Program 1 payment, as well as Other Payment 1 and Other Payment 2. Finance Company's Program 2 payment and Program 3 payment are Other Payment 1 and Other Payment 2 paid to compensate qualifying Brand Retailer for Contract because Finance Company pays Other Payment 1 and Other Payment 2 only when it purchases Contract and each payment is tracked to a specific Contract. Therefore, all payments under Retailer Program are amounts paid to acquire Contract.

As additional support for its argument that Retailer Program payment is a deductible sales and marketing expense, Taxpayer describes Retailer Program payment as analogous to Taxpayer's subvention payment. Taxpayer explains that, in both circumstances, the difference between the principal amount of Contract and the fair market value of Contract is attributable to Taxpayer's promotion to sell Brand Product to Brand Purchaser. Therefore, according to Taxpayer, the amount Finance Company pays to acquire Contract is its principal amount but, like subvention payment, Retailer Program payment is a deductible sales and marketing expense. We disagree with Taxpayer's argument that Retailer Program payment is a deductible sales and marketing expense because it is similar to subvention payment. The structure and economics of the Retail Program payment and the subvention payment are not the same.

Finance Company pays the principal amount for Contract with a below-market interest rate. Taxpayer's subvention payment reimburses Finance Company for the difference only pursuant to Taxpayer's below-market interest rate promotion. Because Brand Purchaser ultimately benefits from this arrangement, subvention payment resembles a sales or marketing expense because it encourages the sale of Brand Product.

In contrast, under Agreement, Finance Company's Retailer Program includes the amount Finance Company agrees to pay as compensation to Brand Retailer for a below-market, at-market, or above-market Contract. Retailer Program provides a direct benefit to Brand Retailer. However, Retailer Program provides little, if any, benefit to Brand Purchaser who is unlikely to know that Finance Company's buy rate is less than Contract rate Brand Purchaser negotiates with Brand Retailer.

For the reasons discussed, Finance Company's payment pursuant to Retailer Program is not analogous to subvention payment. However, even if the payments were similar, the "actual transaction doctrine" precludes Taxpayer from asserting that the form of Retailer Program payment reflects the substance of Finance Company's purchase of Contract but should be equated, for tax purposes, with Taxpayer's subvention payment -- an alternative form of the transaction which Taxpayer could have chosen, but did not choose, to undertake. *See Commissioner v. National Alfalfa Dehydrating & Mill & Co.*, 417 U.S. 134, 148-149 (1974) ("a transaction is to be given its tax effect in accord with what actually occurred and not in accord with what might have occurred").

Finance Company's Retailer Program payment to Brand Retailer to purchase Contract is an amount paid to acquire an intangible debt instrument. Therefore, under § 1.263(a)-4(b)(1)(i) and § 1.263(a)-4(c)(1), Taxpayer must capitalize Retailer Program payment.

CAVEAT(S):

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