OFFICE OF
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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated March 24, 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:

X Corp.	=
Y Corp.	=
M	=
N	=
O	=
$a	=

ISSUE(S):

Whether X Corp.=s transfer of $a to AM@ mutual funds resulted in significant long-term benefits, requiring the entire amount to be capitalized pursuant to I.R.C.' 263.

CONCLUSION:

X Corp.=s transfer of $a to AM@ mutual funds resulted in significant long-term benefits, requiring the entire amount to be capitalized pursuant to I.R.C. ' 263.

FACTS:

The facts you have provided are as follows:

Overview

X Corp. is a large commercial bank. During the , commercial banks in the United States were generally losing market share (as a percentage of total assets in major financial institutions) and mutual funds were gaining.[1] In response to this trend, one of the taxpayer=s competitors, Y Corp., began setting up proprietary mutual funds. It set up AM@ mutual funds in , then one, or two more each year through , reaching a total of proprietary mutual funds as of . Y Corp. served as the investment adviser for each of these funds, with its investment adviser fee increasing with the amount of assets in each fund. Aside from the initial Aseed money@ used to get the funds started, which was redeemed back to Y Corp. once sufficient outside investors were attracted, Y Corp. did not own any shares of these mutual funds.

In , Y Corp. merged into X Corp. X Corp. took over Y Corp.=s role as investment adviser for the AM@ mutual funds. In , X Corp. reported $ in investment adviser fees from its mutual funds (one more fund was started in). Generally, the AM@ funds included equity funds, bond funds, and money market funds. Two of the money market funds were the AN@ fund and AO@ fund. Both of these funds included sizable investments in U.S. government agency structured securities. Most of that $

[1] According to the Federal Reserve, commercial banks= market share (as a percentage of total assets, year-end) declined from % in to % in . During the same period, mutual funds= market share increased from % to %. Federal Reserve data reprinted in George Kaufman, *The U.S. Financial Systems 162 (1995).*

in investment adviser fees in came from the AN@ fund ($), another $ came from the AO@ fund.

Events in

Apparently intending to build on its mutual fund success, X Corp. created more proprietary mutual funds in . However, turned out to be a very bad year for two of X Corp.=s mutual funds, AN@ and AO.@ When interest rates rose in February and , , the value of these Astructured securities@ fell. The rate of return for these two funds became less competitive, and investors redeemed their shares in droves. Fund assets had to be sold to meet the heavy rate of redemptions. Losses on the sales of fund assets reduced the net asset value (NAV) of both the AN@ fund and the AO@ fund.

Under Security Exchange Commission rule 2-a-7 the board of directors of an investment company must take action to eliminate the deviation between the NAV and $1.00 per share value of the fund shares when the NAV falls below $0.996 as of the end of . Thus, X Corp. was faced with a difficult set of choices.

First, it could do nothing, thus allowing these two funds to Abreak a dollar,@ or Abreak net asset value.@ In this case, the funds would have to re-value their shareholders shares to conform with the reduced total fund assets, and notify the shareholders that they now held fewer fund shares than before. X Corp. was not aware of this ever having been done by a money market mutual fund, however, it believed this would have a disastrous impact on its future mutual fund business and other security related businesses. Further, although X Corp. had no legal obligation to bail out these funds, it was nevertheless concerned about possible lawsuits by fund shareholders if the funds did Abreak a dollar.@

X Corp.=s second option was to purchase fund assets Aat par@ and hold them to maturity. This was apparently rejected immediately, because the purchase price of approximately $ exceeded readily available funds, would be hard to keep out of the press, and would subject X Corp. to even bigger losses if interest rates continued to rise, all of which could result in shareholder suits by X Corp.=s own shareholders.

Lastly, X Corp. could bail out the funds by simply transferring funds to the AN@ fund and to the AO@ fund in the amount of the losses suffered by the funds. X Corp. chose this option. During , , and of , X Corp. transferred a total of $a to these two funds. Apparently, X Corp. has never, either before or after , made any other similar Abail out@ transfers to any of its proprietary mutual funds.

X Corp. called these transfers Acapital contributions,@ but neither the transferor nor the transferee treated the transfers as Acapital.@ X Corp. treated the transfers as currently deductible expenses. The funds in effect treated the transfers as capital gains, offsetting realized losses to raise the funds= NAV=s.

In addition to X Corp.=s $a of Acapital contributions@ to the two AM@ funds, X Corp. Avoluntarily waived@ portions of its investment adviser fees due from the AM@ funds. X Corp. reported a total of $ in investment adviser fees for from the AM@ funds (down from the previous year=s $). X Corp. did not report an additional $ in investment adviser fees due from the AN@ and AO@ funds that X Corp. Awaived.@

X Corp.=s Stated Reasons for Bailing Out the AM@ Funds

An internal memorandum dated , states (in its entirety):

> This is to document the reimbursement on of a Capital Loss by the M, N, and O Mutual funds. The attached contribution is to avoid damage to the Company=s goodwill and reputation and to avoid potential mutual fund shareholder litigation and/or shareholder redemptions.

A internal memorandum to X Corp=s AAudit and Examining Committee@ of the board of directors explained the reasons for these Acontributions@ in greater detail:

> The decision to make the cash capital contributions to support and build the funds, as proprietary mutual funds, was made in part in response to the trend of the Bank=s core customer base turning away from insured deposit products and turning towards uninsured non-deposit investment products, like mutual funds over the last several years. More importantly, sales of proprietary mutual funds helps the Bank defend its core retail franchise. Furthermore, X Corp.=s proprietary mutual funds appear to have substantial profit potential. Attached is a summary (Exhibit C) of a Mutual Fund Task Force that conducted a review of proprietary and non-proprietary mutual fund distribution and sales business.

In other words, X Corp. viewed mutual funds as a serious threat to its traditional commercial bank business. The AExhibit C@ attached to the memorandum consisted of a memorandum dated , and various charts and graphs from the Mutual Fund Task Force report. It reached the same conclusion:

There are two important economic reasons for X Corp. to support and build its proprietary mutual fund distribution and sales business:

1) In the intermediate and long term X Corp. needs to respond to the basic trend of disintermediation from insured deposit products to uninsured mutual funds and investment products in order to sustain its core retail customer franchise.

   As a related issue, mutual fund providers are not only capturing significant share of discretionary assets, but they are also cross-selling traditional core bank products (e.g., checking accounts, credit cards, and other credit products) to their mutual fund customers. As a result, the extensive deposit disintermediation has allowed mutual fund providers a foothold in other core financial services and products.

2.) X Corp. has substantial profit opportunity to leverage its existing product and service capabilities to deliver mutual fund products.

X Corp. expected net income before taxes to be $, $, $, and $ for , , , and , respectively. Another chart attached to the memorandum showed the AAnnual Deposit Disintermediation Rate,@ and concluded:

> Since , deposit institutions have lost % share of household discretionary assets (falling from % share in to % share in) while mutual fund providers have increased by % (from % in to % in). Also, the rate of disintermediation increased during .

Another chart attached to the memorandum showed the AAnnual Attrition Rates for X Corp. Retail Deposit Customers.@ The chart showed a greatly reduced attrition rate for retail deposit customers who were also AM@ funds purchasers compared to the attrition rate for non-mutual funds purchasers.[2]

Primary Purpose

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[2] Annual attrition rates for X Corp.=s retail customers with mutual fund purchases ranged from % to %, whereas the attrition rate without mutual fund purchases ranged from % to %, according to an internal study.

In summary, X Corp.=s internal memorandums describe a number of reasons for bailing out the two AM@ mutual funds:

1. Avoid damage to X Corp.=s goodwill and reputation.
2. Avoid potential mutual fund shareholder suits.
3. Avoid mutual fund shareholder redemptions.
4. Support and build X Corp.=s proprietary mutual funds, which was seen as
a) helping X Corp. defend its core retail franchise, and
b) having substantial profit potential in its own right.

LAW AND ANALYSIS

It is well-established that deductions are a matter of legislative grace and the taxpayer bears the burden of proving entitlement to the deduction sought. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). To qualify as an allowable deduction under I.R.C. ' 162(a) an item must be (1) paid or incurred during the taxable year; (2) for carrying on any trade or business; (3) an expense; (4) a necessary expense; and an ordinary expense. Commissioner v. Lincoln Sav. & Loan Ass=n, 403 U.S. 345, 352 (1971). Whether an expenditure is Aordinary and necessary@ is a question of fact to be decided on the basis of all the facts and circumstances. Commissioner v. Heininger, 320 U.S. 467, 475 (1943); Hearn v. Commissioner, 309 F.2d 431 (9th Cir. 1962), aff=g 36 T.C. 672 (1961). Moreover, inherent in the phrase "ordinary and necessary" is a standard of reasonableness. Commissioner v. Lincoln Electric Co., 176 F.2d. 815, 817 (6th Cir. 1949), cert. denied, 338 U.S. 949 (1950); United States v. Haskel Engineering & Supply Co., 380 F.2d 786, 788 (9th Cir. 1967).

In general, an expense is Anecessary@ if it is Aappropriate and helpful@ to the operation of the taxpayer=s trade or business. Welch v. Helvering, 290 U.S. 111, 113 (1933). An expense is Aordinary@ if it is considered Anormal, usual, or customary@ in the context of the particular business out of which it arose. Deputy v. Dupont, 308 U.S. 488, 495-496 (1940). An expense that creates a separate and distinct asset is not Aordinary.@ Commissioner v. Lincoln Sav. & Loan Ass=n, 403 U.S. at 354; see also Norwest Corp. & Subs. v. Commissioner, 112 T.C. 9 (1999). Nor is an expense Aordinary@ when it generates a significant long-term benefit that extends beyond the end of the taxable year. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87-88 (1992); see also Lykes Energy, Inc. & Subs. v. Commissioner, T.C. Memo. 1999-77. No current deduction is allowed for a capital expenditure. See Section 263(a); INDOPCO, Inc v. Commissioner, 503 U.S. 79, 83; see also FMR Corp. & Subs. v. Commissioner, 110 T.C. 30 (1998); PNC Bancorp, Inc. v. Commissioner, 110 T.C. 27 (1998).

I.R.C. ' 263(a) 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)-2 sets forth examples of capital expenditures, including the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year.

Although the Code and regulations use the term Aproperty,@ which connotes the presence of an asset, section 263(a) has been interpreted broadly by the Service and the courts. In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) the Supreme Court upheld the disallowance of a current deduction for fees and expenses incurred by a target corporation to facilitate a friendly acquisition. The taxpayer rationalized the merger to its shareholders by stating that the merger would produce potential synergistic benefits when the taxpayer=s business was combined with the acquiring corporation=s business.

The taxpayer had argued that its merger expenses were not creating or enhancing a capital asset, and thus were not subject to capitalization treatment under section 263(a). The Court, however, held that an expense must be capitalized if it creates a significant long-term benefit, even if that benefit is not an asset per se. The Court concluded that there were two long-term benefits present in the case: (1) the potential synergistic benefit created through combining with a larger corporation, and (2) the benefits created through the transformation from a publicly held corporation to a wholly owned subsidiary.

The Supreme Court stated that A[a]lthough the mere presence of an incidental future benefitBAsome future aspect@--may not warrant capitalization, a taxpayer=s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.@ INDOPCO, 503 U.S. at 87. Moreover, the Court recognized that Athe decisive distinctions between current expenses and capital expenditures are those of degree and not of kind,@ and that Aeach case turns on its special facts.@ Id. at 86 .

In Connecticut Mut. Life Ins. Co. v. Commissioner, 106 T.C. 445 (1996), the taxpayer made a $20 million contribution to a voluntary employees= beneficiary association (VEBA II) trust. The sole issue for decision was whether taxpayer was entitled to a section 162(a) deduction for its $20 million contribution. Applying INDOPCO, supra, the court inquired into the duration and extent of any benefits that the taxpayer received as a result of its $20 million contribution. The Tax Court found the taxpayer effectively prefunded a substantial portion of its anticipated holiday pay obligations for several years through its contribution.

An expert witness opined that the contribution was sufficient to pay holiday pay benefits for 8 to 10 years. Because the $20 million contribution to the VEBA II trust resulted in a substantial future benefit, the court held the contribution must be capitalized.

In FMR Corp. v. Commissioner, 110 T.C. 430 (1998), the Tax Court again applied the INDOPCO analysis. FMR earned substantial investment adviser fees from its family of mutual funds. The issue was whether FMR was entitled to a section 162(a) deduction for expenditures incurred in launching 82 new mutual funds (formally known as Aregulated investment companies@ or ARIC=s@). Citing Connecticut Mut. Life Ins., supra, the court inquired into the duration and extent of benefits FMR received as a result of its costs. The court found that in addition to potential future revenue from the individual contracts with each new RIC, the new RIC=s were expected to produce synergistic benefits to FMR=s entire family of funds. For example, new RIC=s provided existing and future investors greater investment options leading to continued and increased investments in FMR=s family of funds. Moreover, because FMR=s fees were based in large part on the amount of assets under management, FMR would ultimately receive more revenue from the increase in RIC=s it managed.

The Tax Court also observed that FMR itself regarded the launching of new mutual funds as a long-term proposition and generally anticipated that it could take several years, even decades, for a new fund to become successful. Thus, the court concluded that FMR contemplated and received significant long-term benefits as a result of the expenditures it incurred in the creation of 82 RIC=s. The future benefits derived from these RIC=s were not merely incidental. Because FMR expected to realize, and indeed did realize significant economic and synergistic benefits from its long-term relationships with the newly formed RIC=s, the court held the expenditures did not qualify for deduction as Aordinary and necessary@ business expenses under section 162(a).

As the Supreme Court noted in Commissioner v. Tellier, 383 U.S. 687, 689-690, the principal function of the term Aordinary@ in section 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures. A capital expenditure is not an Aordinary@ expense within the meaning of section 162(a), and is, therefore, not currently deductible. Commissioner v. Lincoln Sav. & Loan Ass=n, 403 U.S. 345, 353 (1971); Section 263(a). Whether an expenditure may be deducted or must be capitalized is a question of fact. The Adecisive distinctions between current expenses and capital expenditures are those of degree and not of kind. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 86 (1992); see also, FMR Corp. & Subs. v. Commissioner, 110 T.C. 30 (1998).

We believe the $a must be capitalized because X Corp. realized significant long-term benefits. X Corp.=s AM@ funds were one of the largest family of bank-managed funds in the country. It became involved in the mutual fund business because its core customer base was turning away from traditional bank insured deposit accounts and turning toward uninsured investment products such as mutual funds. As previously noted, since 1985, deposit institutions, like X Corp. had lost 9% of household discretionary assets while mutual fund providers had increased by 9%. Moreover, an internal study showed that attrition rates for X Corp.=s retail deposit customers who were also AM funds purchasers was greatly reduced compared to the attrition rate for non-mutual funds purchasers.

Thus, X Corp.=s mutual funds provided existing and future customers with greater investment options leading to continued and increased investments in X Corp.=s family of funds and other bank products. In addition to defending its core retail customer franchise, the AM@ funds also had a substantial profit potential as well. For instance, X Corp. expected net income before taxes to be $, $, $ and $ for , , , and , respectively. Moreover, X-Corp.=s investment adviser fees were based in large part on the amount of assets under management. Consequently, X Corp. would ultimately receive more revenue from the increase in investors. Thus, like <u>FMR=s</u> RIC=s, X Corp.=s proprietary mutual funds produced Asynergistic benefits@ to its entire banking business.

By transferring $a into the AM@ funds to avoid Abreaking a dollar,@ X Corp. averted potentially disastrous consequences and continued to realize these significant long-term benefits. For instance, X Corp. avoided massive shareholder redemptions and prevented damage to its goodwill and reputation. It also averted potential lawsuits by AM@ funds= shareholders and by X Corp.=s own shareholders. Thus, the transfers prevented the above, helped reduce depositor attrition rates, supported its core retail banking franchise, and protected the substantial profit potential of the funds. Accordingly, the long-term benefits were not merely incidental, but significant as in <u>Connecticut Mut. Life Ins. Co.</u>, <u>supra</u>, and X Corp. realized the benefits well beyond the year in which the transfers occurred.

In sum, X Corp. was faced with a long-term threat from the mutual fund providers. It sought to meet that threat by acquiring proprietary mutual funds. As evidenced by X Corp.=s internal memorandums, these funds significantly reduced retail deposit attrition and was a source of substantial profit. If X Corp. had allowed the AN@ and AO@ funds to Abreak a dollar,@ these funds could have collapsed, shattering market confidence in the entire AM@ family of funds and bringing down X Corp.=s long-term strategy. Thus, we concur X Corp. received significant long-term benefits from the transfer of $a to the AM@ mutual funds requiring capitalization.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

We understand that X Corp. believes the $a it transferred to bail out the AM@ funds is currently deductible as an ordinary and necessary business expense under I.R.C. ' 162(a). As noted earlier, section 162(a) allows as a deduction Aall the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.@

We recognize that the $a was paid during the taxable year for carrying on X Corp.=s trade or business. Admittedly, it was Anecessary,@ in the sense of being Aappropriate and helpful@ to the operation of X Corp.=s business. Nevertheless, we do not believe that the $a was an Aexpense@ or an Aordinary expense@ capable of deduction under section 162(a). The $a appears to be more in the nature of capital contributions than an expense. X Corp. itself called these transfers Acapital contributions.@ In the unlikely event the amount could be considered an expense, X Corp. would still have to show it was an ordinary expense, <u>i.e.</u>, Anormal, usual, or customary@ in the taxpayer=s business. <u>Deputy v. Dupont</u>, 308 U.S. 488, 495-496 (1940). In other words, X Corp. would have to establish that other banks were making similar payments to bail out proprietary mutual funds. Even if X Corp. were able to show that other banks were making such bail out payments, we believe the $a is not currently deductible, but must be capitalized due to the significant long-term benefits.

If you have any further questions, please call the branch telephone number.

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