DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
JAN 25 1999

OFFICE OF
CHIEF COUNSEL

CC:DOM:FS:IT&A

UILC: 162.05-23, 263.14-00

Number: **199918022**
Release Date: 5/7/1999

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 October 23, 1998. 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 =
Y =
A =
B =

"a" = $
"b" = $
"c" = $
"d" = $
"e" = $
"f" = $
"g" = $
"h" = $
"i" = $

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =
Year 9 =
Year 10 =
Year 11 =
Year 12 =
Year 13 =
Year 14 =
Year 15 =
Year 16 =
Year 17 =
Year 18 =
Year 19 =

ISSUE(S):

Whether X is entitled to a deduction in Year 11 in the amount of "i" for a payment X claims was for the purpose of canceling a contract with Y.

CONCLUSION:

A deduction in Year 11 in the amount of "i" is not warranted based on the facts of this case. However, to the extent X is able to show that an amount was paid exclusively for the purpose of terminating a burdensome contract, X may be entitled to a deduction in Year 11 for that portion of the payment.

FACTS:

We rely on facts set out in your memorandum dated October 23, 1998. In addition, we rely on facts set forth in the Revenue Agent's Report and in the taxpayer's protest.

X is an company, subject to the regulatory authority of the of the State of A and to the jurisdiction of the .

Under the , regulated companies were required to offer to purchase produced by qualified facilities, or by qualified facilities. directed the purchase price to be the same as the incremental cost of .

Pursuant to and to companion legislation in A, X entered into noncancellable contracts with several qualified facilities, including Y. The contracts, , ranged in duration from 5 to 30 years. Rates were designed to pay long term avoided costs for a fixed price and were based on forecasts of the costs and resource mix. At the time many of the contracts were entered into, it was believed would continue to skyrocket. However, did not continue to rise and, as a result, the contract rates as originally determined were significantly higher than market rates, or actual avoided costs. Thus, the contracts were unprofitable to X and similarly situated

In Year 1, X entered into a agreement with Y. The agreement provided that X was to purchase of an as yet unbuilt facility. The plant was completed at the end of Year 4 at a cost of "a," which included intangible costs. The book cost for the plant net of intangibles was "b." Commercial operation of the plant started at the end of Year 4. The term of the agreement was 15 years, from Year 4 until Year 19. The rates to be paid under the contract were established through Year 15.

Beginning in Year 9, X started to renegotiate the structure of several agreements it had entered into. In Year 10, X began to negotiate for the buyout of the contract with Y. According to the examiner's statement of facts, several alternatives were discussed including extending the contract and reducing the facility's . In April of Year 11, X approached Y with the concept of buying out the contract and, at the same time, purchasing the facility. Y contacted X proposing a total price of "c." At this time, Y indicated that in its view the replacement value of the plant was between "d" and "e." X's counteroffer provided for a purchase price for the plant in the amount of "g" and for consideration for termination of the contract in the amount of "d." The final agreement was for an overall price of "f," with "g" being allocated to the price of the facility. Including attorneys fees and other costs associated with the purchase, X paid a total of "h." Out of this total cost, "g" was allocated to the price of the facility and "i" was allocated to the price of terminating the agreement.

A local newspaper article that appeared shortly after the agreement was reached reported that X's Public Relations Department explained that it was not economically feasible to renegotiate the contract without the acquisition of the plant. Further, the article makes clear that the acquisition was intended to eliminate potential competition that might arise when the agreement was terminated.

The agreement to purchase the facility was subject to the approval of . During the proceeding before the , X indicated that it had reached the conclusion that it would not be economical to continue to operate the facility. Several parties intervened including the Town of B, where the facility was located. Specifically, the town expressed concern that X had not utilized all the resources available in considering whether the facility could be operated economically. In the end, X agreed to continue to operate the facility for a minimum of three years. It is our understanding that, in fact, X continues to operate the facility at the present time. In any case, was granted in August of Year 11. The included a provision allowing X to recover the cost of the buy out agreement .

Shortly after the purchase of the plant, at its official opening in November of Year 11, X's president is reported as stating that the needed only some cost adjustments to be a robust competitor in the market .

In Year 11, X incurred costs of in the total amount of "h" in connection with the termination of the agreement and the purchase of the facility. Consistent with its allocation of the total purchase price, X claimed a deduction in the amount of “i.” This represented the purported cost of terminating the agreement, legal and other fees. The amount of “g” was capitalized. The entire deduction has been disallowed.

LAW AND ANALYSIS

I.R.C. § 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a)(1) 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.

The determination of whether an expenditure is capital or ordinary must be based on a careful examination of the particular facts and circumstances of each case. Deputy v. Du Pont, 308 U.S. 488, 496 (1940). Pursuant to section 161, if a cost is a capital expenditure, the capitalization rules of section 263 take precedence over the deduction rules of section 162. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1974). Accordingly, a capital expenditure may not be deducted under section 162 regardless of whether it is ordinary and necessary in the taxpayer’s trade or business.

In determining whether the appropriate tax treatment of a cost is as a capital expenditure or as an ordinary expense, the Supreme Court has indicated that a taxpayer’s realization of benefits beyond the year in which the expenditure is incurred is an important factor. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87-88 (1992). Thus, while the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item. Central Tex. Sav. & Loan Ass’n v. United States, 731 F.2d 1181, 1183 ($5^{th}$ Cir. 1984).

Generally, amounts paid solely to reduce or eliminate expenses are currently deductible under section 162. Cassatt v. Commissioner, 137 F.2d 745, 749 (3d Cir. 1943). To the extent an expenditure produces long-term benefits in terms of reducing future costs, this is a factor indicating capitalization is appropriate. However, the Service takes the position that this benefit alone is insufficient to require capitalization. See Rev. Rul 95-32, 95-1 C.B. 8. A distinction is drawn between amounts that are expended for the use of property or in connection with the production of future income and amounts that are in the nature of damages paid to secure relief from an unprofitable contract. Amounts spent for the use of property or in connection with the production of future income are considered capital expenses, while amounts paid to secure relief from an unprofitable contract are currently deductible business expenses.

In Cleveland Allerton Hotel, 166 F.2d 805 (6th Cir. 1948), the taxpayer owned and operated a hotel on leased land. The lease had an unexpired term of over 80 years when the taxpayer determined that the rent was excessive and decided to purchase the land for $441,250. The evidence showed that the value of the land did not exceed $200,000. The taxpayer tried to deduct the difference between the value of the land and the price paid on the ground that it was paid to be relieved of an unprofitable contract. The Sixth Circuit agreed with the taxpayer, concluding it was appropriate to allocate the difference between the fair market value of the land and the fair market value of the building to the cost of terminating the lease.

In Millinery Center Bldg. Corp. v. Commissioner, 21 T.C. 817, 823 (1954), rev'd on other grounds, 221 F.2d 322 (2d Cir. 1955), aff'd, 350 U.S. 456 (1956), similarly to the case in Cleveland Allerton Hotel, the taxpayer entered into a long-term lease. The lease provided for a 21-year term and two options to renew for two further 21-year periods. At its own cost, the taxpayer constructed a building on the property. Title to the building was in the taxpayer, but at the termination of the lease, title would vest in the owner/lessor. The taxpayer exercised its first renewal option, but shortly thereafter entered into an agreement with the owner/lessor to be released from the lease and to purchase the fee. The price paid was $2,100,000. Id. at 819.

The Tax Court found that the value of the unimproved land was $660,000. Accordingly, the taxpayer contended that the additional $1,440,000 paid was deductible as an ordinary and necessary business expense because it was paid to secure relief from the lease. Relying on Cleveland Allerton Hotel, the taxpayer argued that because it already owned the building, it followed that any amounts paid to the owner/lessor in excess of the value of the land had to have been paid to avoid excessive rental payments.

The Tax Court disagreed and expressly declined to follow Cleveland Allerton Hotel. The court concluded that a taxpayer that purchases a capital asset should not be allowed a business expense deduction for that part of the payment allocable to the cancellation of a burdensome lease. Id. at 823. On appeal, the Second Circuit agreed with this aspect of the case, indicating that the bundle of rights that were purchased were more appropriately characterized as a capital asset than as an ordinary business expense. Millinery Center, 221 F.2d 322, 323 (2d Cir. 1955), aff'd, 350 U.S. 456 (1956). In reaching this result, the Second Circuit noted that the Tax Court had not found that the lease was in fact onerous to the taxpayer. Thus, the court concluded that while the obligations under the lease may have motivated the purchase of the property, they could not change its fundamental nature from the acquisition of a capital asset to mere removal of a burden. Id. at 324.

The case was appealed to the Supreme Court, which specifically cited the conflict between the Second Circuit and the Sixth Circuit in Cleveland Allerton Hotel as grounds for granting certiorari. The Court affirmed the Second Circuit, rejecting the taxpayer's premise that it owned the building prior to its purchase of the land. Millinery Center, 350 U.S. 456, 459 (1956). According to the Court, the only way the taxpayer could continue to enjoy the use of the building after termination of the first lease term was by renewing the lease and paying the stated rent. Id. at 459-460. The Court was not persuaded that the lease payments were excessive, or that any part of the purchase price was paid to secure release from an unprofitable contract. The Court concluded that the purchase price simply represented the cost of acquiring the complete fee to the building and the land, and that a deduction as an ordinary and necessary business expense was unwarranted. Id. at 460.

Obviously, the Sixth Circuit's conclusion in Cleveland Allerton Hotel is somewhat at odds with the Supreme Court's conclusion in Millinery Center, where the Court required the entire amount paid to terminate the lease and to purchase the land and building to be capitalized. However, in deciding Millinery Center, the Court did not make clear whether it was rejecting in its entirety the Sixth Circuit's approach in allocating a portion of the payment to the termination of the lease, or whether it simply concluded that the facts of the case did not warrant the conclusion that the difference between the value of the land and the amount paid was a proper measure of the cost of terminating the lease.

We have taken the position, as set out in PLR9842006, that an allocation may be appropriate under certain circumstances where it is clear that a portion of the payment was for the purpose of terminating an unprofitable contract and where the amount paid to terminate the contract is ascertainable. This interpretation of Millinery Center reconciles it with Cleveland Allerton Hotel, which was not expressly disapproved.

As you have pointed out, in a recent case, U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998), the Tax Court did not allocate a portion of the overall price to the cost of terminating the contract. In U.S. Bancorp, the taxpayer leased a computer for a five-year term under a noncancellable agreement. Less than one year after entering into the agreement, the taxpayer decided that the leased computer did not meet its needs. The taxpayer entered into a rollover agreement with the lessor to lease upgraded replacement equipment. In addition to the lease payments for the upgraded equipment, the agreement called for payment of a rollover charge in the amount of $2.5 million. The taxpayer was required to finance the new lease, including the rollover charge, through the lessor's financing company. The obligation was financed over the five-year term of the second lease. The agreement made it clear that if the replacement equipment had not been financed through the lessor's subsidiary, whatever termination charge the parties had agreed on would have been immediately due and payable.

The taxpayer, an accrual basis taxpayer, claimed a deduction for the entire $2.5 million in the year the agreement was executed. The taxpayer argued the charge was paid to terminate the first lease. The Service disallowed the deduction in full on the grounds that it was a capital expenditure. The Service argued that the rollover charge was not merely paid to terminate the first lease. Rather, the charge secured significant future benefits under the second lease.

The Tax Court agreed with the Service that the rollover charge should be capitalized as a cost of acquiring the second lease. The court did not view the termination of the first lease and the initiation of the second lease as isolated events. In fact, the court found the two events to be inextricably integrated. Accordingly, the court was persuaded that the primary purpose of the charge was to allow the taxpayer the right to use the upgraded equipment covered by the second lease and that the charge was, therefore, capital in nature.

In <u>U.S. Bancorp</u>, the court concluded that there was no ground for making an allocation of a portion of the payment as attributable to the termination of the first lease. <u>Id.</u> at 242. Similarly to the situation in <u>Millinery Center</u>, the Tax Court did not elaborate on this conclusion, except to indicate that it was influenced by the advantage the taxpayer received in being able to finance the charge over the term of the second lease.

We do not believe the position set forth in PLR9842006 is necessarily inconsistent with the Tax Court's conclusion in <u>U.S Bancorp</u>. Although the court did not conclude that an allocation was appropriate in <u>U.S. Bancorp</u>, it certainly did not foreclose the possibility of an allocation under any factual circumstances. The court's comments merely suggest the decision against attempting to allocate a portion of the payment to the cost of terminating the lease was based on the benefits the taxpayer received by financing the payment over the course of the second lease.

In this case, as in <u>U.S. Bancorp.</u>, there is no dispute that X was obligated under an unprofitable long-term contract and that it wanted to terminate the contract. Additionally, as in <u>U.S. Bancorp</u>, X essentially entered into two agreements which were closely related. However, despite the fact that the agreement to terminate the contract probably could not have been achieved without the agreement to purchase the plant, we are not persuaded that the two agreements are incapable of being severed conceptually. In other words, we do not find the agreements in this case to be so inextricably related that the court will necessarily conclude that X's primary purpose in this transaction was to purchase the facility and that, therefore, the entire amount paid should be capitalized.

However, we also disagree with X's position that the entire amount should be deducted as a current expense. It is just as clear in this case as in <u>U.S. Bancorp</u> that the termination of X's obligations under the agreement was only one aspect of the deal. X's acquisition of Y's plant in this transaction was indisputably the purchase of a capital asset. As such, it must be capitalized.

X stresses the fact that the amount of the claimed deduction is fully consistent with the allocation in the agreement. Moreover, X argues that the parties were only able to reach a mutually satisfactory agreement after negotiations that lasted for more than one year. We acknowledge that agreements reached as a result of arm's length bargaining between unrelated parties with adverse legal interests are generally respected by the courts unless there is a reason to question the bona fides of the transaction. Black Industries, Inc. v. Commissioner, T.C. Memo. 1979-61. However, the allocation of values in a contract do not always control for tax purposes and may be increased or decreased in accordance with the facts. Concord Control, Inc. v. Commissioner, 78 T.C. 742, 745 (1982). In this case, while it appears that the overall purchase price resulted from hard bargaining between adverse parties, we do not agree that the parties were adverse with respect to the allocation of the price between the cost of terminating the contract and the cost of purchasing the plant. Thus, an examination of the merits of the allocation in this case is justified.

An analysis of the merits of the allocation in this case will require a determination of the fair market value of the plant at the time of sale. Fair market value is defined as the price a willing buyer would pay a willing seller, both having reasonable knowledge of the relevant facts and neither acting under any compulsion to buy or to sell. United States v. Cartwright, 411 U.S. 546, 551 (1973). The applicable standard is objective, using a hypothetical willing buyer and seller, rather than a particular buyer or seller. Propstra v. United States, 680 F.2d 1248, 1251-1252 (9th Cir. 1982); Buckley v. Commissioner, T.C. Memo. 1994-470. The determination of fair market value is a question of fact. Propstra, 680 F.2d at 1251.

In the instant case, the part of the overall purchase price allocated to the plant was based on an estimated salvage value of "g". The book cost of the plant was "b" and, on the date of sale, the plant had only been in use for seven years. We have reviewed X's arguments on this issue and do not feel they adequately support use of salvage value under these circumstances. Moreover, X's arguments in favor of using salvage value as a measure of the fair market value of the plant largely focus on X's anticipated use for the plant. X's emphasis on subjective, rather than objective, reasons for using salvage value disregards the proper standard for determining fair market value for tax purposes. Although we express no opinion as to the value of the plant, we believe the value should reflect the willing buyer willing seller standard.

In addition, we do not believe the allocation memorialized in the agreement sufficiently addresses other intangible benefits that X was seeking as a result of purchasing the plant. The revenue agent's report references statements made by

X's Public Affairs Department proximate to the time the agreement was reached that suggest the plant was purchased in part to eliminate the competition that Y would represent once the agreement was no longer in place. Thus, to some extent, the payment can be seen as part of a plan to attain a business advantage extending into the indefinite future. In this sense, the instant case is similar to Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 273 F. Supp. 229 (D.S.C. 1967), aff'd, 393 F.2d 494 (4th Cir. 1968), and to Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974).

In Darlington-Hartsville, the taxpayers were bottling companies. For many years they were required to buy Coca-Cola syrup from a middleman who had exclusive rights to bottle the syrup in specified areas of South Carolina. In an effort to eliminate the middleman and acquire the right to purchase the syrup directly from Coca-Cola, the taxpayers entered into negotiations with Coca-Cola. In the end, Coca-Cola agreed to buy the middleman out and liquidate the corporation. The taxpayers reimbursed Coca-Cola for the costs of the stock acquisition and in exchange were awarded contracts to purchase the syrup directly from Coca-Cola. Darlington-Hartsville Coca-Cola Bottling Co. v. United States, 393 F.2d 494 (4th Cir. 1968).

The taxpayers deducted the payments to Coca-Cola, arguing they were made to eliminate burdensome and onerous contracts and were, therefore, ordinary and necessary business expenses. The Service argued the payments were for the purpose of acquiring new and more favorable bottling contracts and, thus, were capital expenditures. Relying on the principle that an expenditure is a capital outlay if it brings about the acquisition of a business advantage extending into the indefinite future, the district court reasoned that the payments were part of a plan to improve the future profits of the taxpayers by eliminating a non-productive middleman and by reducing the base prices paid for syrup. Darlington-Hartsville, 273 F. Supp. at 231. The court concluded that the taxpayer could not deduct as a current business expense the full cost of acquiring an asset, tangible or intangible, which benefitted the taxpayer for more than one year. Id. The Fourth Circuit agreed, indicating that a capital expenditure is distinguished from a current expense by its intendment to produce a positive business benefit whose effect will be reaped in seasons beyond a single year. Darlington-Hartsville, 393 F.2d at 496. Because the payments were designed to procure a less costly syrup and better the taxpayers' profits over future years, the court concluded the payments were a capital investment. Id.

In Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974), the taxpayer was in the business of operating a chain of motels. To further develop the chain of motels, the taxpayer entered into territorial agreements in which it granted exclusive rights to construct Rodeway motels within a certain geographic area. The particular agreement that was at issue in the case covered a period of two years, but could be extended at 2-year intervals until 1994. The agreement was entered into in 1964 and covered a territory including the States of California, Arizona, New Mexico, Colorado and the city of El Paso, Texas. The agreement could not be canceled by the taxpayer unless the other party failed to perform in accordance with the contract terms.

By 1968, the taxpayer had determined it could develop the territory covered by the agreement more effectively on its own. It was concerned that the territory was not being developed as rapidly as necessary for the taxpayer to maintain its competitive position in the industry. Choice motel locations within the territory covered by the agreement were being purchased by competitive chains. The taxpayer believed that canceling the agreement would enhance the value of its motels and yield greater profits in the long run. Accordingly, in August of 1968 the taxpayer paid $100,000 to terminate the territorial agreement.

The taxpayer deducted the payment as a business expense on its 1968 return. The Service disallowed the deduction on the grounds that the payment was a capital expenditure.

The Tax Court agreed that the payment was a capital expenditure. The court likened the situation to one in which a payment is made to acquire a new business. Because the payment was made to enhance the taxpayer's business opportunities in the Southwest area and to provide the opportunity for increased income, it was capital in nature. Id. at 419. The court was also persuaded by the fact that the payment, made in 1968, related to the production of income in future years. The court reasoned that a deduction of the full amount of the payment against income in 1968 would cause a gross distortion of income. Id. at 420. The court rejected the taxpayer's argument that the payment was made to secure release from a burdensome contract. Instead the court found that the payment was a capital expenditure since it was made to acquire the right to conduct a business from which the taxpayer could anticipate earning profits over future years.

As in Darlington-Hartsville and Rodeway Inns, the payment made by X was not solely for the purpose of eliminating a burdensome agreement. To the contrary, here it is undisputed that part of the payment was made to acquire a new business. Although it may not have been clear that X would continue to operate the plant for an extended period, by the time the plant was purchased, X had agreed to operate the plant for at least three years. In any case, the facility was fully operational when it was purchased, giving X the opportunity to enhance its future income if it elected to continue operations.

Moreover, in addition to the acquisition of the plant as a tangible capital asset, the facts suggest that X had strategic reasons for purchasing the plant. The acquisition was intended to improve X's future profits by eliminating a potential source of competition and by providing a means to protect its customer base once the agreement was no longer in effect. Under Darlington-Hartsville and Rodeway Inns such benefits are capital in nature. Thus, to the extent X paid to acquire capital assets or to acquire business advantages extending into the indefinite future, the payments should not be characterized as damages for release from an unprofitable arrangement. Rather, the payments are more appropriately characterized as a capital outlay.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

[redacted]

DEBORAH A. BUTLER
Assistant Chief Counsel

By: *Richard L. Carlisle*
RICHARD L. CARLISLE
Chief
Income Tax & Accounting Branch
Field Service Division