OFFICE OF
CHIEF COUNSEL

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

June 28, 1999

CC:DOM:FS:IT&A
TL-N-54-99
Number: **199941008**
Release Date: 10/15/1999
UILC: 263.00-00;263.03-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ATTORNEY

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated March 22, 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:

Taxpayer	=
$Y	=
a#	=
b#	=
Independent Distributor	=
Parent	=
100% Owner	=
c#	=
Fiscal Year 1	=
Fiscal Year 2	=
d#	=

ISSUES:

1. Whether Taxpayer=s two settlement payments of $Y, to the parent corporation of an independent distributor and to the 100 percent owner of that parent corporation, resolving a legal dispute over the termination of the independent distributor=s right to distribute Taxpayer=s products are deductible under I.R.C. ' 162 or capitalized under section 263.

2. Whether professional service costs, including internal and external accounting and legal fees, incurred in connection with the settlement of the legal dispute are deductible under section 162 or capitalized under section 263.

CONCLUSIONS:

1. Both $Y settlement payments incurred to regain control over its distribution and end the independent distributor=s right to distribute are costs incurred to protect or re-acquire a capital asset, and thus are capital expenditures.

2. The professional fees were incurred for the disposition or acquisition of a capital asset and are thus capital expenditures.

FACTS:

Taxpayer is the United States importer and distributor of products manufactured overseas. Taxpayer distributes the products through a distributor network, which then supplies retailers. Taxpayer has divided its distributor network into a# distribution regions. For the years at issue, a subsidiary of Taxpayer was the distributor in all but b# regions. For those b# regions, Taxpayer had entered into successive distributor agreements with the independent distributors. The issues in this case involve taxpayer and one of its independent distributors (AIndependent Distributor@).

Independent Distributor was owned by a company (AParent@), which was in turn owned by a sole shareholder (A100% Owner@). Parent had entered c# of successive distributor agreements, doing business with Taxpayer for many years. With the approval of Taxpayer, Parent had assigned its rights to distribute in its region to Independent Distributor. Toward the end of one of the distributor agreements, Taxpayer informed Parent and Independent Distributor that Taxpayer would not renew its distribution agreement. Taxpayer intended to regain control over its distribution in this region by having the distribution function performed by its subsidiary.

In response to Taxpayer=s notification of intent not to renew its distributor agreement, Parent and Independent Distributor filed a lawsuit against Taxpayer preventing Taxpayer from ending the distributor arrangement. The parties settled the case.

As part of the settlement, Taxpayer and Parent/Independent Distributor agreed to enter into one Final Distribution Agreement, for a period of d# years, with no extensions or renewals permitted. At the end of that Final Distribution Agreement, Taxpayer would re-acquire the rights to distribute its products in the region and Parent would have no further rights to distribute the products. Another part of the settlement involved an option. Taxpayer acquired an option to acquire the distribution rights two years prior to the expiration of the Final Distribution Agreement. To exercise this option, Taxpayer had to: (1) provide notification by a certain date; (2) pay a set fee to Parent for sales occurring from the time of the option being exercised until the end of the Final Distribution Agreement (a two-year period); and (3) agree to purchase the assets and assume any leases of Independent Distributor (with no amount being paid for going concern value).

Some years into the Final Distribution Agreement, Taxpayer provided the proper notification to exercise its option to acquire the distribution rights of Parent prior to the end of the Final Distribution Agreement. In response, Parent filed lawsuits against Taxpayer and its overseas parent. In reaction, Taxpayer filed a countersuit.

Parent alleged that (1) the Final Distribution Agreement was procured by fraud because Taxpayer underallocated products to Independent Distributor after entering into the Agreement; (2) Taxpayer violated federal laws, including consumer laws; and (3) by engaging in such conduct, Taxpayer was estopped from exercising its rights under the option provision of the Final Distribution Agreement. Taxpayer's countersuit sought declaratory and injunctive relief under the terms and conditions of the Final Distribution Agreement. Parent's lawsuits were designed to unwind the Final Distribution Agreement and to re-open the possibility that Independent Distributor could remain a distributor for Taxpayer. The lawsuits were settled.

To resolve all existing and potential disputes, the parties entered into two supplemental settlement agreements. One agreement was between Taxpayer and Parent/Independent Distributor and the other agreement was between Taxpayer and 100% Owner. The supplemental agreements were treated as amendments to the Final Distribution Agreement. The supplemental agreements terminated all litigation, terminated the relationships, and provided for covenants not to compete. Consistent with the Final Distribution Agreement, Taxpayer purchased the assets and the leases of Independent Distributor and assumed certain liabilities as of the option date. Most significantly, in addition to the purchase of the assets and assumption of the liabilities, Taxpayer agreed to make settlement payments. Two settlement payments were required, one to Parent and one to 100% Owner, for the same amount, $Y. The $Y settlement payment to Parent was payable in five installments. The $Y settlement payment to 100% Owner was payable in one lump sum. Taxpayer made the pro rata and lump sum settlement payments in Fiscal Year 1.

Taxpayer deducted in Fiscal Year 1 the $Y payment to Independent Distributor=s Parent and the $Y payment to 100% Owner as a section 162 ordinary and necessary business expense (Taxpayer capitalized the costs of purchasing the assets of Independent Distributor). Taxpayer also deducted as a section 162 ordinary and necessary expense professional fees incurred in Fiscal Year 1, including payments for outside attorneys, appraisals and arbitration fees, and a portion of in-house fees associated with the acquisition of the Independent Distributor.

LAW AND ANALYSIS

Deduction v. Capitalization

Section 162 generally allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year. Section 263 generally provides that no deduction shall be allowed for the cost of permanent improvements or betterments made to increase the value of any property. Treas. Reg. ' 1.263(a)-2(a) clarifies that section 263 requires the capitalization of costs incurred to acquire property having a useful life substantially beyond the close of the taxable year.

Expenditures that otherwise are deducible under section 162 nevertheless are not deductible currently if they are also capitalizable under section 263. Sections 161 and 261; INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 358 (1971). Expenditures which create or enhance a capital asset must be capitalized. Commissioner v. Idaho Power Co., 418 U.S. 1 (1973).

AIt has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures.@ Woodward v. Commissioner, 379 U.S. 572, 575 (1970). A payment to acquire a business is in the nature of a capital expenditure. Robertson v. Commissioner, 61 T.C. 727 (1974). A payment to acquire (or re-acquire) a franchise and its territory is a capital expenditure. Rodeway Inns of America v. Commissioner, 63 T.C. 414 (1974), acq., 1975-1 C.B. 3.

AThe line of demarcation between currently deductible and capital expenditures is often a shadowy one, and the courts have long struggled with the problem of devising standards for characterizing the costs of litigation.@ Boagni v. Commissioner, 59 T.C. 708, 712-3 (1973) (footnote omitted). The Tax Court and other courts, following the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963), and Woodward v. Commissioner, 379 U.S. 572 (1970), have concluded that the origin and character of the claim with respect to which a settlement payment was incurred governs the tax character of that liability. Entwicklungs & Finanzierungs A.G. v. Commissioner, 68 T.C. 749, 959 (1977), citing Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971); Clark Oil & Refining Corp. v. United States, 473 F.2d 1217 (7th Cir. 1973). Likewise, the origin and character of the claim with respect to which legal and other fees were incurred governs the tax character of the those liabilities. Id.; Boagni, 59 T.C. 708 (1973). For example, legal expenses and settlement payments incurred in defending against a claim that would injure or destroy business are deductible as ordinary and necessary business expenses. But legal expenses and settlement payments incurred to defend or protect title to property are nondeductible capital expenditures. Redwood Empire Savings & Loan v. Commissioner, 628 F.2d 516, 520 (9th Cir. 1980).

If the settlement payment was made to resolve a claim which arose in the process of acquisition of a capital asset or to extinguish a claim involving ownership rights to a capital asset, regardless of the taxpayer=s subjective motivation for agreeing the make the payment, it constitutes a capital expenditure. Entwicklungs & Finanzierungs, 68 T.C. at 760. Under these general provisions, courts have held that legal, brokerage, accounting, and similar costs incurred in the acquisition (or disposition) of such property are also capital expenditures. Woodward, 379 U.S. at 576.

This case involves settlement payments of $Y amount paid to both Parent and 100% Owner. This case also involves professional fees incurred in dealing with the litigation and determining the settlement payments. Accordingly, the determination regarding whether to capitalize or deduct the settlement payments and the legal fees depends on the origin and character of the claim to which the liabilities were incurred.

The origin and character of the claim against Taxpayer giving rise to the settlement payments and professional fees arose out of the distribution rights Taxpayer had negotiated with Parent/Independent Distributor. The distribution rights were embodied in successive distribution agreements Taxpayer had made with Parent/Independent Distributor. Those distribution agreements permitted Parent/Independent Distributor to be the exclusive supplier of Taxpayer=s merchandise in a specific distribution region. Specifically, the claim arose out of Taxpayer=s desire to end the distributorship relationship two years early by exercising its option in the Final Distribution Agreement.

The Taxpayer=s distribution rights are a capital asset as those rights provided the possessor significant long-term benefits (the ability to be the sole source distributor to retailers in a geographic region for as long as Taxpayer=s products were manufactured and sold). See Treas. Reg. ' 1.263(a)-2(a); INDOPCO, 503 U.S. 79. Litigation of Taxpayer=s distribution rights clearly involves a claim to extinguish ownership rights to a capital asset, the distribution agreement. Furthermore, the settlement payments also sprung from a claim to re-acquire the capital asset of the distribution agreement. In either case, because the claim giving rise to the settlement payments involve litigation over a capital asset, costs incurred must be treated as nondeductible capital expenditures and may not be deducted under section 162. Entwicklungs & Finanzierungs, 68 T.C. 749; Redwood Empire Savings & Loan Association, 628 F.2d 516. Likewise, professional fees incurred to litigate and protect the capital asset, incurred in the disposition (or acquisition) of a capital asset are also capital expenditures, which may not be deducted under section 162. Woodward, 379 U.S. 572.

Amortization Period

While the settlement payments and the professional fees must be capitalized, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. INDOPCO, 503 U.S. at 83-4. The concept is to match expense with the revenues of the taxable period to which they are properly attributable. Id. at 84; Commissioner v. Idaho Power Co., 418 U.S. at 16.

Taxpayer desired to end the distributor relationship with Parent/Independent Distributor and perform those functions internally (by having Taxpayer=s subsidiary become the distributor). Parent/Independent Distributor, on the other hand, desired to maintain the relationship in perpetuity. To that end, they had filed suits to prevent Taxpayer from ending the distributor relationship prior to the Final Distribution Agreement. In settlement of the those proceedings, Taxpayer and Parent/Independent Distributor entered into the Final Distribution Agreement. At the time when Taxpayer properly exercised its option to accelerate the termination of the distributor relationship, a new series of suits and countersuits began. Ultimately, with settlement payments made to both Parent and 100% Owner (along with the purchase of the assets and assumption of liabilities and leases), the distributor relationship was terminated.

One argument is that the extinguishment of Parent=s ability to distribute and Taxpayer=s re-acquisition are analogous to a franchiser/franchisee relationship. A payment to acquire (or re-acquire) a franchise and its territory is a capital expenditure, amortizable over the remaining useful life of the agreement. Rodeway Inns, 63 T.C. 414. The Rodeway Inns court analogized to cases involving the termination of a lease prematurely. Such cases hold that the payment is made to obtain possession of property (distribution rights in this situation) for the duration of the lease, and that the payment thus is amortizable over that period, even though the lessor thereby re-acquires the right to deal with the property as it wishes so long as it wishes. Id. at 422 (citations omitted). The settlement payments and the professional fees were incurred after Taxpayer exercised its option under the Final Distribution Agreement. The option permitted Taxpayer to re-acquire its distribution rights two years early. Under Rodeway Inns, a court could determine that the settlement payments and professional fees are amortizable over the remaining period of the Final Distribution Agreement, the two years Fiscal Year 1 and Fiscal Year 2.

Another argument can be made that the expenditures incurred have no ascertainable life. The underlying capital asset, Taxpayer=s distribution rights, will provide revenues to Taxpayer as long as Taxpayer and its parent continue to manufacture and sell their products. The litigation [redacted] prior to the Final Distribution Agreement and the litigation entered into when the option was exercised under the Final Distribution Agreement involved the ability to be the sole source distributor to retailers in a geographic region for as long as Taxpayer=s products were manufactured and sold. The ownership rights to the capital asset, distribution rights, has an unknowable useful life. Taxpayer extinguished Parent=s ability to distribute and re-acquired its rights to distribute its products in a geographical region.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

We believe the stronger argument is that the amortization period is for the final two years of the Final Distribution Agreement, following Rodeway Inns. Taxpayer is re-acquiring its distribution rights, and is merely doing so in advance of when it was to receive those rights. That is, by entering into the Final Distribution Agreement, Parent/Independent Distributor had already contracted away their rights to distribute Taxpayer=s products upon the completion of the Final Distribution Agreement. Taxpayer=s exercise of the option merely accelerated by two years the relinquishment of the distribution rights.

Arguing for no amortization entails greater hazards of litigation. To make this argument, you would need evidence that [redacted]

If you have any further questions, please call (202) 622-7900.

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