INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
July 13, 2001

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CASE MIS No.: TAM-113781-00/CC:ITA:B3

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer	=
Facility	=
County A	=
Investment Bankers	=
Law Firm	=
$ a	=
$ b	=
$ c	=
$ d	=
$ e	=
$ f	=
$ g	=
$ h	=
$ i	=
$ j	=
$ k	=
$ l	=
$ m	=
date 1	=
date 2	=
date 3	=
date 4	=
date 5	=
year 1	=
year 2	=
year 3	=

year 4	=
year 5	=
year 6	=
t	=
v	=
w	=
x	=
y	=
z	=

ISSUE:

Are costs incurred by Taxpayer to modify certain leases capital expenditures under § 263 of the Internal Revenue Code or deductible expenses under § 162?

CONCLUSION:

The costs incurred by Taxpayer to modify certain leases must be capitalized under § 263 and amortized over the term of the modified leases.

FACTS:

Taxpayer is the operator of Facility, an electric generating station in County A. In the early 1980s, Taxpayer used the proceeds from tax-exempt pollution control bonds issued by County A ("original bonds") to construct certain pollution control facilities at Facility. The aggregate principal amount of the original bonds was $ a. The original bonds were initially payable from and secured by revenues derived by Taxpayer under a lease and sublease agreement between County A and Taxpayer ("Financing Agreement"). To secure its rental obligations under the Financing Agreement, Taxpayer executed and delivered a promissory note, which was pledged as security for the benefit of the purchasers of the original bonds.

On date 2, Taxpayer entered into a series of six agreements in which it sold and leased back its entire interest in Facility ("Facility Leases"). The property transferred included the pollution control facilities discussed above. Under each agreement, Taxpayer was the seller and a particular grantor trust was the purchaser. Each agreement was identical except with respect to the identity of the six beneficiaries of the grantor trusts and the percentage ownership interest acquired by each beneficiary. Each of the grantor trusts leased its respective interest in the Facility back to Taxpayer in identical leases dated date 1.[1] The term of each lease was t years, or until date 5.

[1] According to the dates of the documents provided by Taxpayer, the leases from the grantor trusts, as lessor, to Taxpayer, as lessee, apparently were executed prior to the date on which the parties entered into the sale and leaseback transaction.

Under the original sale and leaseback arrangement between Taxpayer and the purchasing grantor trusts ("Lessors"), Lessors assumed Taxpayer's payment obligations to County A under the Financing Agreement. Accordingly, under the Facility Leases, the total rental payments to be made by Taxpayer were to equal at least that amount sufficient to pay principal and interest with respect to the original bonds.[2]

According to Taxpayer, by year 1, interest rates in the public market for tax-exempt bonds had decreased substantially from the rates at which the original bonds had been issued. However, Taxpayer could not take advantage of the more favorable financing conditions because the original bonds had become the legal obligation of Lessors pursuant to the sale/leaseback transaction. Thus, Taxpayer approached Lessors and requested that they refinance the original bonds and pass along the benefit of a reduced interest rate to Taxpayer in the form of reduced rental payments under the Facility Leases.

On date 3, Taxpayer and Lessors amended their "Participation Agreement," which governs the overall sale/leaseback transaction, in order to provide Taxpayer with the right to request that Lessors refinance the original bonds. In accordance with this amendment, Lessors must take such actions as are reasonably requested by Taxpayer for refinancing, provided that Taxpayer comply with certain conditions. These conditions include a requirement that Taxpayer pay any bond premium, accrued interest, "Gross-up Payment," and other out-of-pocket expenses, incurred by either party, to Lessors as "supplemental rent" under the Facility Leases. Taxpayer was required to reimburse, inter alia, Lessors and County A for all out-of-pocket costs and expenses incurred in connection with any refinancing (or attempted refinancing) permitted by the amendment.

Also in year 1, the Owner Participant[3] and Taxpayer amended their Tax Indemnification Agreement under which they agreed that the Owner Participant would be allowed to deduct bond premium and to amortize refinancing expenses over the term of the new bonds.

In year 2, Taxpayer and Lessors reached an agreement under which Lessors agreed to retire the original bonds and replace them with new bonds. As a result of the refinancing, the interest rate of the new bonds declined from x% to y%. The due date

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[2] Taxpayer represents that the rental payments were actually much higher than the amount of the principal and interest due on the original bonds, as the pollution control facilities constituted only a small portion of the Facility transferred to Lessors under the sale/leaseback arrangement.

[3] The Owner Participant consists of six undivided interest owner participants in the Facilities and appears to be the same as the six beneficiaries of the grantor trusts comprising the Purchaser/Lessors.

of the new bonds remained the same as the original bonds: date 4.[4] The terms of the agreement included the following:

1. Taxpayer would pay all the out-of-pocket costs associated with the refinancing and would indemnify Lessors against any and all claims, losses, expenses suffered by Lessors as a result of the refinancing.

2. Lessors would receive a benefit from Taxpayer equal to z% of the annual savings realized as a result of the refinancing of the original bonds.

3. The primary terms of the Facility Leases between Taxpayer and Lessors would be extended for a period of v years. (This optional extension provision was contained in the original lease.)

4. The rental payments made by Taxpayer under the Facility Leases would be reduced to reflect the lower interest rate obtained through the refiancing (that is, w% of the annual savings realized as a result of the refinancing).

Taxpayer paid a "refunding bond premium" in the amount of amount $ c that was expensed as supplemental rent for both financial reporting and federal income tax purposes.[5] In addition, Taxpayer paid Investment Bankers $ d in year 1 for "lease advisory services" and $ e in year 2 for "underwriting." Taxpayer retained and paid Law Firm $ f in year 1 and $ g in year 2 for acting as "bond counsel" with respect to the defeasance of the original bonds and the issuance of the new bonds. In addition, Taxpayer paid Lessors $ h in year 2 as reimbursement for their professional fees associated with "lease negotiations." Taxpayer received a credit on its semiannual rental payments for year 3 and year 4 to recover some or all of these costs before Lessors received their z% benefit payment.

Taxpayer represents that the bonds (old and new) are tax-exempt bonds issued on behalf of Lessors by County A. They are not obligations of Taxpayer and are not issued with respect to facilities owned by Taxpayer. Taxpayer further represents that it has no right to compel either Lessors or County A to issue new bonds. Taxpayer contends it paid all expenses of the bond refinancing transaction to Lessors as "supplemental rent" and accordingly deducted these amounts for financial accounting and federal income tax purposes when incurred and actually paid. These deductions totaled $ i in year 1 and $ j in year 2. The proper treatment of these payments, which total approximately $ k, is the subject of this request for technical advice.

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[4] Taxpayer projected its savings in reduced rental payments from the decrease in the interest rate of the new bonds would be approximately $ b per year.

[5] The proper treatment of the refunding bond premium is not at issue in the request for technical advice.

LAW AND ANALYSIS:

The field asserts that the lease modification costs at issue in this case are properly capitalized under § 263. By contrast, Taxpayer contends that they are deductible currently under § 162.

Section 162 generally allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. By contrast, § 263 prohibits deductions for capital expenditures, which include any amounts paid for permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-2(a) of the Income Tax Regulations clarifies that § 263 requires the capitalization of costs incurred to acquire property having a useful life substantially beyond the close of the taxable year. Thus, an ordinary expense may be fully deducted during the taxable year, while a capital expenditure must be depreciated over the life of the asset or benefit with which the expenditure is associated. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992); Commissioner v. Idaho Power Co., 418 U.S. 1, 18 (1973), Commissioner v. Lincoln Savings & Loan Assn, 403 U.S. 345, 358 (1971).

An expenditure that "serves to create or enhance . . . a separate and distinct" asset should be capitalized under § 263. Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 354 (1971); Central Texas Savings & Loan Ass'n v. United States, 731 F.2d 1181, 1184 (5th Cir. 1984); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 782 (2d Cir. 1973). Further, the Supreme Court held, in INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992), that creation of a separate and distinct asset may be a sufficient, but is not a necessary condition to classification as a capital expenditure. Thus, in INDOPCO, the Court held that legal and investment banking expenses incurred by a target corporation in a friendly takeover were capital, even though they did not serve to create a separate asset, because the change in corporate structure would provide substantial benefits to the corporation beyond the close of the taxable year.

With regard to leases, the case law is clear that a lease of real estate constitutes a capital asset to the lessee. See, e.g., University Properties, Inc. v. Commissioner, 378 F.2d 83, 83 (9th Cir. 1967); Fitzsimmons v. Commisioner, 37 T.C. 179, 184 (1961). Thus, any amount paid to acquire a lease in excess of the reasonable rental value is a capital expenditure which must be amortized over the entire term of the lease. University Properties, Inc. v. Commissioner, 378 F.2d 83, 83 (9th Cir. 1967); Fitzsimmons v. Commissioner, 37 T.C. 179 (1961); Main & McKinney Bldg. Co. v. Commissioner, 113 F.2d 81, 81-2 (5th Cir. 1940); Baton Coal Co. v. Commissioner, 51 F.2d 469, 469 (3d Cir. 1931). Other types of expenses incurred in the acquisition or modification of a lease are also capital expenditures. See, e.g., U.S. Bancorp v. Commissioner, 111 T.C. 231 (1998); Denver & Rio Grande Western Ry. Co. v. Commissioner, 32 T.C. 43, 51-2 (1959), aff'd on other grounds, 279 F.2d 368 (10th Cir. 1960) (expenses incurred to draft a lease assumption agreement); Lieber v. Commissioner, T.C. Memo 1993-391 (financial advisory fees paid to obtain lower interest rates on mortgages paid pursuant to leases).

In University Properties, for example, the petitioner leased a tract of land with office buildings from a university for a term of 35 years. Four years later, petitioner and the university entered into a supplemental lease to include additional land and to provide that petitioner would manage the construction of a new building on some of the premises. The supplemental lease required petitioner to make “additional rent” payments of $80,000 for the first three years after the supplemental lease was signed. The court held that these payments were capital in nature because they represented consideration for the addition of land and a construction management project to the lease terms, assets which would provide benefits to the petitioner beyond the three years during which the additional payments were made.

Rev. Rul. 73-176, 1973-1 C.B. 146, also considered the issue of the treatment of payments made in accordance with a lease modification agreement. There, the taxpayer-lessee entered into a 20 year lease for five floors of an office building which was then under construction. The rent was calculated on a per square foot basis. After executing the lease but before the building was completed, the lessee determined it needed less office space. The lessee entered into a modification agreement providing for a reduction in square footage and a corresponding reduction in rent. As consideration for the changes to the original lease, the modification agreement required the lessee to pay an amount of “additional rent” in monthly installments during the first five years of the lease. The revenue ruling concludes that the additional payments are capital in nature, because they constituted consideration for a release from lessee’s future obligations to occupy more lease office space and pay higher rent during the lease term of 20 years.

In the instant case, Taxpayer’s stated purpose in requesting that Lessors retire the original bonds and issue new ones was to obtain a lower interest rate, which would translate directly into a reduction in Taxpayer’s rental obligations under the Facility Leases over the next z years.[6] The entire lease modification transaction was driven by Taxpayer’s desire to continue leasing the electric station at a substantially reduced price – a total savings of approximately amount $ l during the remaining term of the initial lease. Like the petitioner in Rev. Rul. 73-176, the monies expended by Taxpayer in order to obtain this lease modification are capital in nature because they constitute consideration for a release from Taxpayer’s future obligation to pay an additional $ m in rent each year through year 5.

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[6] Although the “out-of-pocket” costs were based in large part on Lessors’ costs to restructure debt by retiring the original bonds and replacing them with a new bond issue, these costs do not constitute debt restructuring costs to Taxpayer. Taxpayer was not a co-obligor on the new bond issue, and was thus not legally responsible for the debt or the costs associated with obtaining it. Taxpayer reimbursed Lessors for their debt restructuring costs as a condition to obtaining the modified Facility Leases. Thus, Taxpayer incurred these costs in connection with the lease modifications.

In support of its position that the expenditures at issue are currently deductible, Taxpayer relies on a series of authorities concerning the cancellation of economically burdensome contracts. Montana Power Co. v. United States, 171 F. Supp. 943 (Ct. Cl. 1959); Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948); Casset v. Commissioner, 137 F.2d 745 (3d Cir. 1943). These authorities are inapplicable here, because Taxpayer did not cancel any contracts. Taxpayer and Lessors entered into modifications of numerous agreements concerning the leases of Facility and the rights and obligations surrounding the debt financing, but it did so with the same parties and concerning exactly the same subject matter. In fact, the modifications to the Facility Leases, titled "Facility Lease Supplement No. 2," provide for a reduction in rental payments to reflect the new, lower interest rate of the reissued bonds and for an extension of the lease term until year 6, and specifically state that, otherwise, all provisions of the original leases remain in "full force and effect."

Taxpayer also argues that the expenditures at issue are deductible because they were incurred solely for the purpose of reducing the amount of future rental payments due under the leases. In some case, the courts have held that amounts paid or incurred to reduce or eliminate expenses are currently deductible. See Cleveland Allerton, 166 F.2d at 807 ("The usual conception of capital assets is that of property devoted to the production of income. . . . but funds expended by way of liquidated damages for release from contract do not ordinarily buy capital assets."); T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 587 (1993) ("Expenditures designed to reduce costs are also generally deductible."). See also Rev. Rul. 95-32, 1995-1 C.B. 8 ("although [taxpayer's] expenditures may reduce future operating and capital costs, these kinds of benefits, without more, do not require capitalization of these expenditures").

In this case, however, Taxpayer is not merely reducing its future costs; instead, it is modifying and extending its leases, which are capital assets in the hands of Taxpayer. Thus, Taxpayer's situation is similar to that in U.S. Bancorp, 111 T.C. 231. In that case, the taxpayer was required to capitalize a $2.5 million charge it paid to a lessor in connection with terminating a lease for a mainframe computer system and initiating a second lease involving upgraded mainframe computer equipment. The termination/rollover charge was required to be capitalized and amortized over the life of the second lease. The Tax Court found that the expenditures at issue were not merely lease termination charges, but instead were charges to acquire an additional leasehold. In so finding, the court relied on Pig & Whistle Co. v. Commissioner, 9 B.T.A. 668 (1927), and Phil Gluckstern's, Inc. v. Commissioner, T.C. Memo. 1956-9. In each of those cases, the taxpayer made a lump-sum payment to acquire a leasehold, which was amortized over the term of the lease. The lease was canceled and the parties entered into a second, extended lease on the same property. The unamortized portion of the original lump-sum payment was required to be capitalized and amortized over the term of the second lease. In substance, the second lease was viewed as a continuation of the first lease in modified form, so that any unrecovered costs were considered to be costs of the modified lease.

In the instant case, Taxpayer may have incurred the expenditures at issue solely for the purpose of reducing its future rental payments. However, viewing the transaction as a whole, it is clear that Taxpayer's expenditures resulted in the acquisition of an additional leasehold with a useful life extending substantially beyond the end of the taxable year. Thus, the costs incurred by Taxpayer to modify the Facility Leases must be capitalized under § 263 and amortized over the term of the modified leases.

CAVEAT(S)

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