subject: Deductibility of Payment of Underwriting Costs

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent. This memorandum supplements a prior memorandum issued to you on Date 6.

LEGEND

$X = 
$Y = 
A% = 
Agreement D = 

Agreement E = 
Agreement F = 
Agreement G = 
Agreement H =
Amount P = 
Amount Q = 

B% = 
Company C =

Date 1 = 
Date 2 = 
Date 3 = 
Date 4 = 
Date 5 = 
Date 6 = 
Date 7 = 
Debt M =
Debt N = 
Floating Rate A =
K Years = 
Operation Z = 
Statement Q = 

Statement Z = 

XYZ = 
Year 1 = 

ISSUES

1. Whether the taxpayer may deduct a $X payment under Treas. Reg. § 1.163-7(c) or whether such payment must be capitalized under Treas. Reg. § 1.263(a)-5
when the payment was to compensate XYZ for underwriting costs in relation to Debt N.

CONCLUSIONS

1. The payment must be capitalized under Treas. Reg. § 1.263(a)-5 because the payment was to compensate XYZ for the underwriting costs associated with Debt N.

FACTS
LAW AND ANALYSIS

I.R.C. § 1275(a)(1)(A) defines “debt instrument” as “a bond, debenture, note, or certificate or other evidence of indebtedness.”

Section 1001(a) provides that the gain (or loss) from the sale or other disposition of property is the difference between the amount realized and the adjusted basis.

Section 1001(b) provides that the amount realized is “the sum of any money received plus the fair market value of the property (other than money) received.”

Treas. Reg. § 1.1001-1(a) provides that “the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained.”

Section 1.163-7(c) provides that “if a debt instrument is repurchased by the issuer for a price in excess of its adjusted price . . ., the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs. If the issuer repurchases a debt instrument in a debt-for-debt exchange, the repurchase price is the issue price of the newly issued debt instrument (reduced by any unstated interest within the meaning of section 483).”
Section 1.263(a)-5(a)(9) provides that taxpayers must capitalize amounts paid to facilitate a borrowing. A borrowing is defined as any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization. A borrowing also includes debt issued in a debt for debt exchange under § 1.1001-3.

Section 1.263(a)-5(b) provides that:

[A]n amount is paid to facilitate a transaction described in paragraph (a) of this section if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but not determinative. . . . An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange.

Section 1.263(a)-5(j) provides that “[n]othing in this section changes the treatment of an amount that is specifically provided for under any other provision of the Internal Revenue Code (other than section 162(a) or 212) or regulations thereunder.”

Section 1.446-5(a) provides rules for allocating debt issuance costs over the term of the debt. Debt issuance costs are those transaction costs incurred by an issuer of debt (borrower) that are required to be capitalized under section 1.263(a)-5.

Debt issuance costs (such as underwriting costs, commissions, and other costs related to the issuance of a debt instrument) generally are capitalized and amortized or deducted over the term of the debt instrument to which the costs related. See, e.g., Enoch v. Commissioner, 57 T.C. 781, 794 (1972) (loan fees must be capitalized over the life of the loan); Lovejoy v. Commissioner, 18 B.T.A. 1179, 1181-82 (1930) (commissions, fees, and printing costs paid in securing a loan must be capitalized over the period of the loan); Lay v. Commissioner, 69 T.C. 421 (1977) (loan fees and other costs of securing a loan had to be capitalized over the life of the loan). “Amounts paid for services rendered in connection with a loan constitute capital expenditures which must be amortized over the term of the loan.” Sleiman v. Commissioner, T.C. Memo. 1997-530, 1997 WL 727732, at *8.

In Denver & Salt Lake Railway Company, the court held that costs of polling bondholders were capital expenditures where such costs were in anticipation of and an integral part of a proposed merger with the taxpayer’s parent pursuant to the parent’s reorganization plan, even though the taxpayer was not technically a party to the reorganization at the time the expenses were incurred. The court stated:
It is true that petitioner was not technically a party to a reorganization at the time it incurred the disputed expenses. It is also true that such amounts might possibly be said to have been expended to acquire a modification in petitioner's outstanding bond issue, which was advantageous to it. Nevertheless, the fact remains that petitioner made such expenditures in anticipation of and as an integral part of its proposed merger with the Denver and Rio Grande. Furthermore, what advantages there were accruing to petitioner, in the modification sought by it, were contingent upon and did not accrue to it unless and until the actual merger occurred. We, therefore, are of the opinion that being so inextricably tied in with the proposed plan of reorganization and with petitioner's participation therein, the expenditures in question must necessarily be considered as part of the expenses thereof. This being true, they represent capital expenditures and as such, are not deductible.


Therefore the issue is whether Company C paid Amount Q as a repurchase premium or whether the amount was paid to facilitate the subsequent sale of Debt N. Compare Treas. Reg. § 1.163-7(c) with Treas. Reg. § 1.263(a)-5. In the former case, Company C would be entitled to a deduction. See Treas. Reg. § 1.163-7(c). In the latter case, Company C would have to capitalize the payment over the term of the debt. See Treas. Reg. §§ 1.263(a)-5, 1.446-5(a).

Amounts paid to facilitate the issuance of debt must be capitalized. See § 263(a)-5(a)(9). Section 1.263(a)-5(b) provides that an amount is paid to facilitate a transaction if it is paid in the process of investigating or otherwise pursuing the transaction.

Therefore, Company C paid Amount Q in the process of pursuing the issuance of Debt N and the amount must be capitalized as a facilitative cost. See § 1.263(a)-5(a)(9), (b); *Enoch*, 57 T.C. at 794; *Lovejoy*, 18 B.T.A. at 1181-82; *Lay*, 69 T.C. 421; *Sleiman*, T.C. Memo. 1997-530, 1997 WL 727732, at *8.

However, the payment of Amount Q would not be subject to section 263(a) if the payment was made to repurchase Debt M (a repurchase premium) See §§ 1.262(a)-5(j), 1.163-7(c), 1.1001-3(e)(2)(iii). The facts show that Company C paid Amount Q to compensate XYZ for costs it was to incur in connection with the sale of Debt N, not as a
repurchase premium associated with the reacquisition of Debt M. The following facts support this conclusion:

Thus, the payment compensated for the underwriting costs for the sale of Debt N and must be capitalized. See Treas. Reg. § 1.263(a)-5; Enoch, 57 T.C. at 794; Lovejoy, 18 B.T.A. at 1181-82; Lay, 69 T.C. 421; Sleiman, T.C. Memo. 1997-530, 1997 WL 727732, at *8.


Moreover, Company C is required to capitalize the payment even if it was not technically a party to the sale of Debt N. See Denver & Salt Lake Ry. Co., 24 T.C. at 719.

Amount Q was paid to facilitate the sale of Debt N, it must be capitalized. See Treas. Reg. § 1.263(a)-5.
Simply put, the payment did not relate to Debt M, which was retired, but to Debt N, which debt is still outstanding, and must be capitalized over the life of Debt N.

It is well established that if an expenditure has its origin in the acquisition, enhancement, or disposition of a capital asset, the expenditure must be capitalized without regard to the motivation for incurring the expenditure. See Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels, 397 U.S. 580 (1970); United States v. Gilmore, 372 U.S. 39 (1963). It is the origin and character of the claim for which the expenditure is incurred that determines the nature of the expenditure for federal income tax purposes. Gilmore, 372 U.S. at 44. The taxpayer agreed to pay underwriting costs and did pay those costs.
As discussed previously, underwriting costs must be capitalized. See Treas. Reg. § 1.263(a)-5; Enoch, 57 T.C. at 794; Lovejoy, 18 B.T.A. at 1181-82; Lay, 69 T.C. 421; Sleiman, T.C. Memo. 1997-530, 1997 WL 727732, at *8.

Finally, Denver & Salt Lake Railway Co. does apply. This case stands for the proposition that expenditures inextricably tied in with the proposed plan of reorganization and with petitioner’s participation therein should be considered reorganization expenses and capitalized. Here, the expenses at issue were inextricably tied with the sale of Debt N and should be capitalized accordingly.

The payment at issue clearly represents a payment for underwriting costs and must be capitalized pursuant to under Treas. Reg. § 1.263(a)-5 and deducted over the term of Debt N under § 1.446-5.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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(Large Business & International)

By: __________ /s/ ____________________

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