Office of Chief Counsel
Internal Revenue Service

memorandum

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JMMarr

date:

to: John Niederst, Exam Case Manager
Ralph Strope, Exam Team Coordinator
Internal Revenue Service, Group 1672
P.O. Box 2488
Pittsburgh, PA 15230

from: Joyce M. Marr, Attorney (LMSB)
June Y. Bass, Associate Area Counsel (LMSB)

subject: [redacted]
Tax Year: [redacted]

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Former Revenue Agent [redacted], who had been assigned to provide support district assistance in this case pursuant to IRM Handbook No. 4.3.11, Section 4.4, requested our advice on the deductibility of a $[redacted] payment made by the [redacted] (hereinafter, "the Taxpayer") to [redacted]. As agreed, we are addressing our response to you. This memorandum should not be cited as precedent.

Issues

1. Whether $[redacted] paid by the Taxpayer to [redacted] pursuant to Section 6.2 of the "Joint Development Agreement," which is set forth in pertinent part below, is deductible as a current expense or should be capitalized under I.R.C. § 263?

2. If the $[redacted] payment must be capitalized, whether the $[redacted] may be amortized?

Conclusions

1. The Taxpayer must capitalize the $[redacted] it paid to [redacted] pursuant to Section 6.2 of the Joint Development Agreement.

2. The $[redacted] payment may be amortized pursuant to section 197.

Facts

The Taxpayer and [redacted] entered into a "Joint Development Agreement," dated [redacted] a copy of which is affixed hereto as Exhibit A. In Section 6 of the Joint Development Agreement," the Taxpayer agreed to approach [redacted], with reasonable assistance from [redacted], with respect to joining in the development of [redacted] (the Joint Interoperability Specification) such that [redacted], [redacted] and the Taxpayer would be equal "partners."[1] Section 6.2 of the Joint Development Agreement states, in pertinent part, as follows:

> 6.2 [redacted] shall attempt to persuade [redacted] to join with [redacted] and [redacted] as set forth in this Section 6. Should [redacted] not join within [redacted] days from [redacted], [redacted] shall pay [redacted] United States Dollars ($[redacted]).... If within [redacted] days after [redacted], [redacted] joins [redacted] and [redacted], then [redacted] shall be entitled to a return of [redacted] ([redacted]%) of the amount [redacted] has paid [redacted] under this Section 6.2.

Since [redacted] did not join [redacted] and the Taxpayer in the development of the Joint Interoperability Specification within [redacted] days from [redacted], the Taxpayer paid $[redacted] to [redacted] pursuant to Section 6.2 of the Joint Development Agreement. Despite the provision requiring reimbursement of [redacted]% of such amount to the Taxpayer, the Taxpayer was not reimbursed any portion of the $[redacted].[2]

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[1] The reason the Taxpayer had to secure another [redacted] company, such as [redacted], to make [redacted] for [redacted] with its [redacted] technology, was that the Taxpayer did not have sufficient production capacity.

[2] The Examination Division has not requested our advice as to the tax effect of the Taxpayer's failure to receive this reimbursement.

Affixed hereto as Exhibit B is a memorandum dated [redacted], from [redacted][3] written in response to the Service's query as to why [redacted] agreed to make this $[redacted] payment to [redacted]. Also affixed hereto as Exhibit C are: (1) an Information Document Request (IDR) in which the Taxpayer was asked, among other things, why it was necessary to make the $[redacted] payment; (2) a response to the IDR; and (3) an "Additional Response" to the IDR.

As stated in the [redacted] memorandum (Exhibit B), from [redacted]'s perspective, the $[redacted] payment "was necessary to guarantee them that they would not lose revenue in the event that there was a delay in [redacted] becoming a party to the Joint Interoperability Specification development team." From the Taxpayer's perspective, it was necessary that its [redacted] be used by a [redacted] manufacturer, such as [redacted], with "strong brand name recognition" that could "withstand the market lead" of the [redacted] and [redacted] alliance.

The Taxpayer deducted the full $[redacted] paid to [redacted] for its tax year ended [redacted].

Discussion

Deductions are a matter of legislative grace and the burden of clearly showing the right to a claimed deduction is on the taxpayer. INDOPCO v. Commissioner, 503 U.S. 79, 84 (1992), (quoting Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943)). I.R.C. § 162 allows a deduction for all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Treas. Reg. § 1.162-1(a) states that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. However, capitalization under section 263 takes precedence over a current deduction under section 162 . I.R.C. § 161. See also INDOPCO, 503 U.S. at 84.

Section 263(a) of the Code provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments to increase the value of any property or estate. Section 263 reflects the basic principle that a capital expenditure may not be deducted from current

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[3] According to information we have found on the Internet, in [redacted], the Taxpayer spun-off its [redacted] systems business, now known as [redacted], to its shareholders.

income. Commissioner v. Idaho Power Co., 418 U.S. 1 (1974). An expenditure is capital if it creates or enhances a separate and distinct asset or if the expenditure produces a significant long-term benefit. See INDOPCO, 503 U.S. at 79. While the mere fact that a taxpayer may receive some future benefit from an expenditure does not require capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is an important factor in determining whether the expenditure is deductible in the year incurred or must be capitalized. INDOPCO at 87-88.

We believe that the $[redacted] payment must be capitalized by the Taxpayer because when [redacted] and [redacted] joined in the development of the Joint Interoperability Specification with the Taxpayer, the Taxpayer expected to realize significant economic benefits beyond the tax year from their effort. In fact, since the $[redacted] was paid before the Joint Interoperability Specification effort began, it resulted in predominantly future benefits. Thus, the $[redacted] payment should be capitalized pursuant to section 263(a).

The second issue is whether the $[redacted] may be amortized. I.R.C. § 197 was added to the Internal Revenue Code by the Omnibus Budget Reconciliation Act of 1993. It provides for the amortization ratably over 15 years of the adjusted basis of certain acquired intangible assets, including "customer-based intangibles." See I.R.C. § 197(d)(1)(C)(iv). The term "customer-based intangible" refers to the composition of a market, a market share, and any other value resulting from the future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers. I.R.C. § 197(d)(2).

The Taxpayer was motivated to "secure[] the support and commitment of [redacted] in pushing [the] [redacted] technology" because [redacted] was "a [redacted] manufacturer that had strong brand name recognition," thus giving it a competitive advantage in the market. Accordingly, it seems that the $[redacted] payment was made to secure [redacted]'s market share and thus, is subject to amortization as a "customer-based intangible" pursuant to section 197.

This advice has been coordinated with the Office of Chief Counsel. With the rendition of this advice, we are closing our file. Please contact the undersigned at telephone number (949) 360-2688 if you have any questions or comments concerning the foregoing.

JOYCE M. MARR
Attorney (LMSB)

Attachments: As stated