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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Tax Years Involved:

Date of Conference:

LEGEND:

Taxpayer:
Product M:

Country A
Country B
Year 1
Year 2
Year 3
Year 4
Year 5
Year 6
Year 7
Year 8
Year 9
Year 10
Year 11
X

205

ISSUE:

Whether Taxpayer may deduct under § 162 of the Internal Revenue Code certain consulting fees incurred to develop a transfer pricing methodology ("TPM") and negotiate an advance pricing agreement ("APA"), or whether Taxpayer must capitalize those fees under § 263.

CONCLUSION:

Taxpayer may deduct under § 162 the consulting fees incurred in developing a TPM and negotiating an APA.

FACTS:

Taxpayer is in the business of producing and distributing Product M. During its Year 1 tax year, Taxpayer began contemplating whether to apply to the Internal Revenue Service for an APA with respect to various transactions between Taxpayer and certain related companies in Country A and Country B. At the time, the Service was considering the proposal of significant transfer pricing adjustments under § 482 with respect to such transactions for tax years beginning in Year 2, and had already proposed such adjustments for the Year 3 and Year 4 tax years.[1] Taxpayer viewed the APA as a possible vehicle for developing a TPM agreeable to the Service, as well as the tax authorities in Country A and Country B, that would serve as a basis for resolving all actual and potential disputes with the Service for prior tax years and for avoiding such disputes in future years. During its Year 5 tax year, Taxpayer filed an application for an APA pursuant to Rev. Proc. 91-22, 1991-1 C.B. 526,[2] to cover its Year 5 through Year 6 tax years. While the application was pending, Exam suspended its consideration of transfer pricing adjustments for the tax years under audit, and Appeals suspended its consideration of proposed transfer pricing adjustments for prior tax years.

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[1] Section 482 authorizes the Service to allocate income among related companies when it determines that a taxpayer has employed transfer prices that do not reflect an arm's length price. The regulations under § 482 provide that a taxpayer must establish a TPM between related companies that reflects the "best method" to achieve an arm's length price. An APA memorializes the Service's determination that a specific TPM reflects the "best method" for a particular taxpayer under the arm's length standard of § 482.

[2] Rev. Proc. 91-22 has been superseded by Rev. Proc. 96-53, 1996-2 C.B. 385.

To assist Taxpayer in developing a TPM, Taxpayer's outside legal counsel retained the economic consulting firm of X. X developed a TPM that was proposed as part of the APA application and then worked with Taxpayer and the Service over the next several years to make appropriate modifications to the TPM as negotiations proceeded. X rendered monthly bills for its services and Taxpayer currently deducted the amounts billed for both financial reporting and federal income tax purposes. Taxpayer began using a version of the TPM for internal pricing purposes in its Year 7 tax year and reported operating results based on these prices for both tax and financial accounting purposes.

In Year 6, following an agreement reached by the competent authorities of the United States and Country A, Taxpayer and the Service formally entered into an APA for its Year 5 through Year 6 tax years.[3] In conjunction with the execution of the APA, the Service agreed to impose no transfer pricing adjustments for Taxpayer's Year 2 through Year 8 tax years and to withdraw its proposed adjustments for Years 3 and 4.

By the time the APA was finalized in Year 6, it had already expired. Thus, pursuant to section 11.08 of Rev. Proc. 96-53, Taxpayer filed a request with the Service to renew the APA for its Year 10 through Year 11 tax years. Negotiations between Taxpayer and the Service on this renewal have been progressing but no formal agreement has yet been reached.

In the course of its examination of Taxpayer for the Year 8 through Year 9 tax years, the Service has proposed to capitalize under § 263 the fees paid to X. During these years, the fees were incurred for X to develop the TPM and to assist in negotiating the APA with the Service. These activities culminated in the adoption of the APA for the Year 5 through Year 6 tax years and the use of the TPM to resolve transfer pricing issues for the Year 3 through Year 8 tax years.

LAW AND ANALYSIS:

Section 162 provides that taxpayers may deduct all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. See also § 1.162-1(a) of the Income Tax Regulations. Under § 162, a taxpayer may generally deduct ordinary and necessary business expenses paid or incurred in connection with the determination, collection, or refund of any tax (hereinafter referred to generally as "tax compliance costs"). Tax compliance costs include expenses paid

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[3] The competent authority of Country B was not prepared to participate in the negotiations and thus did not agree to the TPM.

or incurred for tax counsel, in connection with the preparation of tax returns, in connection with any proceeding involved in determining the extent of tax liability, or in contesting tax liability. See § 212(3) and § 1.212-1(a).[4] See also Rev. Rul. 89-68, 1989-1 C.B. 82 (fees paid to a tax practitioner to prepare and submit a request for a ruling, as well as the related user fee paid to the Service, are deductible by an individual under § 212). In the instant case, Taxpayer incurred costs to comply with § 482 through the APA process. Thus, the fees paid to X in this regard are tax compliance costs.

Section 263(a) prohibits a deduction for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. See also § 1.263(a)-1(a). The amounts referred to in § 263(a) include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Section 1.263(a)-2(a).

Under these rules, the Supreme Court has held that taxpayers must capitalize the costs of creating or acquiring a separate and distinct asset with a useful life extending substantially beyond the end of the taxable year. See Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971). In addition to this "separate and distinct asset" standard, the Supreme Court has also held that taxpayers must capitalize costs under § 263 if they generate significant future benefits. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). All deductions that are otherwise allowable under § 162 are subject to these capitalization standards. See § 161. Thus, tax compliance costs are allowable as deductions under § 162 only if they are not required to be capitalized under § 263.

The determination of whether tax compliance costs are capital expenditures depends on the facts and circumstances of the particular situation. Rev. Rul. 67-401, 1967-2 C.B. 123 (costs incurred by a taxpayer in applying for a letter ruling in connection with a research and development project are not research and experimental

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[4] Section 212(3) allows a deduction to an individual for all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax. Section 1.212-1(a) provides that expenses are deductible if paid or incurred by an individual for tax counsel or in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability. Similarly, § 162 broadly allows a deduction for these costs when incurred by a taxpayer engaged in a trade or business.

expenditures but are ordinary and necessary business expenses or capital expenditures, depending on the facts of the particular case). For example, the costs of tax advice directly related to a capital transaction must be capitalized. Honodel v. Commissioner, 722 F.2d 1462 (9th Cir. 1984) ("[T]he deductibility of any expense related to tax advice or assistance must still turn on whether the origin of the tax-related expense was ordinary and necessary, or was a capital acquisition or disposition.") (citing Woodward v. Commissioner, 397 U.S. 572, 577 (1970) and Lincoln Savings, 403 U.S. at 354); Rev. Rul. 67-125, 1967-1 C.B. 31 (legal fees incurred by a corporation in securing advice on the tax consequences prior to the consummation of a merger, a subsequent stock split, and a proposed distribution in redemption of a portion of the outstanding stock are capital expenditures).

The agent argues that the fees paid to X should be capitalized because the TPM and the APA provided Taxpayer with a significant future benefit. This benefit was the potential reduction of Taxpayer's future tax compliance costs for the years covered by the APA. However, the reduction of future costs, without more, is not a sufficient ground for capitalization. See T.J. Enterprises, Inc. v. Commissioner, 101 T.C. 581, 589 (1993) (amounts paid to majority shareholder to prevent her from causing an increase in royalty rates were currently deductible); Rev. Rul. 95-32, 1995-1 C.B. 8 (expenditures that reduce a utilities' future production costs are deductible); Rev. Rul. 94-77, 1994-2 C.B. 19 (severance payments made to employees in connection with a business down-sizing are deductible even though they may produce some future benefits, such as reducing future operating costs and increasing operating efficiencies). Thus, with regard to both the TPM and the APA, we believe the fees paid to X did not provide Taxpayer with the type of significant future benefits necessary to require capitalization.

We also do not believe that either the TPM or the APA constitutes a separate and distinct asset within the contemplation of § 263(a). Instead, based on the facts and circumstances set forth above, we conclude that the fees paid to X are merely tax compliance costs that did not create a separate and distinct asset or provide Taxpayer with significant future benefits. Moreover, the fees did not relate to an otherwise capital transaction. Thus, Taxpayer may deduct under § 162 the consulting fees paid to X in developing the TPM and negotiating the APA.

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.