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Article

IRS Confirms Loan Commitment Fees Are Deductible Business Expenses

By Mark Leeds and Brennan Young[1]

The deduction for interest has been under some pressure lately. In particular, the Tax Cuts and Jobs Act (P.L. 115-97) recently amended Section 163(j) of the Internal Revenue Code of 1986, as amended (the "Code"), to place substantial limitations on the ability of all taxpayers to deduct "business interest."[2] Thus, costs and expenses of obtaining credit that are deductible, but are not treated as interest expense, are particularly attractive to borrowers. On June 22, 2018, the US Internal Revenue Service ("IRS") released a "legal advice issued by field attorneys" (a "LAFA"), LAFA 20182502F[3] (the "Advice"), holding that a borrower in a lending transaction is entitled to deduct unused commitment fees as ordinary business expenses. The Advice provides a short roadmap for borrowers to take advantage of this treatment in other lending transactions.

In the Advice, the taxpayer entered into a revolving credit agreement with a third party lender for a term of five years. The purpose of the loan was to fund general corporate activities. The agreement required the taxpayer to pay a quarterly commitment fee (in addition to other fees not disclosed in the Advice). The amount of the quarterly commitment fee was calculated based on the average daily unused amount of the total commitment during the previous quarter multiplied by a percent, which varied based on the taxpayer's credit rating at time each fee was calculated. Such fees are commonly referred to as "unused commitment fees."

In addition to unused commitment fees, many lending facilities carry other fees. The main types of fees consist of (1) upfront fees (fees paid from a borrower to a lender at or before issuance), (2) facility fees (fees paid based on the total amount of the commitment of a facility, regardless of amounts drawn) and (3) utilization fees (fees paid based on the amount of debt outstanding to the borrow under a facility), among others. The tax treatment of these fees has an impact on both the deductibility of such fees to the party paying the fee and on the determination of whether withholding will be required if a particular fee is paid to a non-US person not in connection with the conduct of a US trade or business.

The treatments of the various fees commonly present in lending facility transactions vary for federal income tax purposes. The Advice supports a dichotomy between the federal income tax treatment for commitment fees for credit (fees based on the current amount of unissued commitment) and that for unused commitment fees (lending fees based on the unused amount of a commitment to loan money). This article discusses IRS guidance on the various types of fees. It also considers planning opportunities for borrowers to structure fees incident to lending transactions to be treated as ordinary and necessary business expenses under Code § 162. This treatment will avoid fees being treated as interest expense, potentially being disallowed under Code § 163(j) or causing other interest expense to be disallowed.

Treatment of Certain Borrower Fees

COMMITMENT FEES TO ACQUIRE CREDIT

Prior to the issuance of the Advice, the IRS had consistently treated commitment fees as premiums paid for the option to borrow money, that is, granting the borrower the right to sell debt securities containing pre-specified terms to the lender for a fixed price. In Revenue Ruling 81-160, 1981-1 C.B. 312,[4] the IRS ruled on the treatment of commitment fees paid by a would-be borrower. In the facts of the ruling, the commitment fee was determined based upon the amount of unissued debt. The IRS held that the loan commitment fees were in the nature of a standby charge that resulted in the acquisition of a valuable property right, that is, the right to borrow money.

Revenue Ruling 81-160 reasons that a commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the IRS treats the commitment fee as a cost of acquiring the loan that is to be deducted ratably over the term of the loan. While Revenue Ruling 81-160 is not explicit on the point, the IRS has held in other contexts that the commitment fees should not be treated as interest expense.[5] Commitment fees, as a cost of acquiring the loan, are amortized over the term of the loan.[6] If the right is not exercised, the borrower may be entitled to a current loss deduction.

In TAM 8537002 (May 22, 1985), the IRS considered the treatment of fees substantially similar to commitment fees from the perspective of the recipient of such fees. Specifically, the IRS considered whether fees for issuing credit card should be treated as fees for services or for the acquisition of a property right, specifically, the right to borrow money. The IRS noted that a credit card fee is "similar to a loan commitment fee, i.e., a fee charged for making money available for a loan." Accordingly, the IRS held that the principle of Revenue Ruling 81-160 applied because "the character of the loan commitment fee should be the same on both the income and expenditure side." Thus, the credit card fees were held to be a payment for a property right and not a fee for services.[7]

FACILITY FEES

Facility fees are fees paid in consideration for a credit facility to remain open. In contrast to commitment fees, the amount of a facility fee is typically based on the total amount of the commitment of a facility, regardless of what portion of such commitment is actually outstanding debt. In TAM 200514020, the IRS distinguished facility fees from commitment fees. The loan agreements in TAM 200514020 allowed the obligors to draw letters of credit or loans based on a maximum outstanding balance computed with respect to both obligations, and repayments of either created additional capacity to draw new loans or letters of credit. In exchange for the right to borrow and draw letters of credit, the borrower paid a facility fees to the lenders. The facility fee was computed with respect to the total available balance that could be drawn under the letters of credit and as loans. The facility fee was not affected by the amount outstanding as loans or letters of credit.

The IRS held that the rule promulgated by Revenue Ruling 81-160 was inapplicable to the facility fee. The holding of Revenue Ruling 81-160 was based on the fact that the commitment fee created an opportunity for the borrower to sell loans. In contrast, the facility fee was payable regardless of the amount borrowed. The IRS held that facility fees were "akin to maintenance charges which are currently deductible." The IRS, in reaching its conclusion, noted that "facility fees did not produce significant future benefits for the Taxpayer." Although the TAM does not directly state the exact nature of facility fees, the TAM implicitly treats the facility fees as fees payable to the lenders for the provision of credit. Such fees are not in the nature of interest because they are not in respect of the cost of borrowed money. The fees are payable to ensure that the line of credit is available.

UPFRONT FEES

Treasury Regulation § 1.1273-2(g)(2) provides that payments from a borrower to a lender in connection with a lending transaction (other than fees for services or property) are not treated as fees. Instead, such fees are treated as reducing the issue price of the loan. Various authorities apply this rule, even when the loan is provided through a loan facility and not through a term loan the proceeds of which are immediately advanced to the borrower.[8]

In CCA 200019041,[9] the IRS considered the tax treatment of prepaid interest on loans made by insurance companies on policyholder loans. Prior to the promulgation of Treasury Regulation § 1.1273-2(g)(2), the IRS had ruled that insurance companies were required to include prepaid interest in income. Following the promulgation of the regulation, however, the IRS held, "[P]repaid interest reduces a loan's issue price." Accordingly, in the CCA, the IRS held that the prepaid interest was not immediately taxable to the insurance company but only created a discount on the loan.

The application of the rule described in Treasury Regulation § 1.1273-2(g)(2) is not entirely clear when borrowers under the credit agreements pay upfront fees, but do not immediately borrow money. In those cases, the principal amount of the loan cannot be reduced by the amount of the upfront fee. However, upfront fees are costs incurred for the extension of credit and are commonly treated as reductions in the issue price of the loans when amounts are ultimately borrowed pursuant to the credit agreements. Under this analysis, the additional discount would be treated as interest income and recognized over the life of any actual loan.

It may not be easy to distinguish between upfront fees and commitment fees in a given case. If the fees for the lending transaction are paid in installments, instead of in a single upfront payment, there appears to be a stronger case for the treatment of the fees as commitment fees. This may be the case even though the cost of obtaining the credit is economically the same. Of course, the documentation will also be a factor. Fees are more likely to be treated as commitment fees if the fees are referred to as such.

UTILIZATION FEES

Utilization fees are generally paid by a borrower based on the amount of a facility outstanding to the borrower. One school of thought is that the treatment of such fees depends on the measurement of such fees. If the utilization fee is paid only if the borrower incurs liabilities in excess of a floor amount, such fees could be treated as additional interest income because, in this case, the utilization fees are being paid to compensate the lenders for the risk that the borrower has become indebted over a certain amount. In contrast, if the utilization fees are paid because the amount of obligations incurred by the borrower is below a specified amount, the utilization fee can be considered akin to a commitment fee because the fee is imposed on the unused commitment of the lending group.

The Advice

The Advice concludes the unused commitment fees are currently deductible as ordinary and necessary expenses under Code § 162 as long as such fees are not capital expenditures. In reaching this conclusion, the Advice considers whether the commitment fees were (a) amounts paid to acquire an intangible asset (i.e., the right to borrow money) in a purchase or similar transaction or (b) amounts paid to create an intangible. In either case Code § 263 and the regulations thereunder would require such fees to be capitalized (and therefore not be currently deductible). The Advice concludes that the unused commitment fees are not capital expenditures because:

> [The Unused] Commitment Fees are commonly and frequently incurred in the type of business conducted by the Taxpayer and are appropriate and helpful to the development of the Taxpayer's business, and therefore the payment of the Commitment Fees is an ordinary and necessary expense under § 162.

The Advice next considers whether the commitment fees are the amount paid for an option to borrow money. In contrast to the treatment under Revenue Ruling 81-160 discussed above (i.e., treating a commitment arrangement as a borrower's option to sell securities), the Advice states that the unused commitment fees were not paid to create an option because the fees, paid quarterly, were related to the rights and benefits maintained by the taxpayer during the three-month period *prior* to the date the payment was due under the agreement. The IRS contrasted this treatment with an option to sell securities in the future. In other words, it appears that the Advice concludes that in situations where the amount of a borrower's commitment fee is measured based on a formula using the amount of unused issued capacity in a facility in arrears, the IRS will not view the commitment arrangement as a put option held by the borrower to sell debt securities.

The Advice goes on to state that even if the payment of a commitment fee was an amount paid to create an option, the option would only relate to the three-month period preceding the payment date (and would not extend beyond the close of the taxable year) and, accordingly, the timing of the taxpayer's deduction under the taxpayer's method of accounting would clearly reflect income on the facts of this case.

Looking Forward

The Advice provides very favorable treatment of unused commitment fees paid quarterly in arrears. Given the cross-reference in the Advice to Revenue Ruling 81-160, and without the Advice fully contridicting the same, it is unclear whether commitment fees paid in other contexts could be treated in the manner treated in the Advice. It is also unclear whether the analysis in the Advice would apply to commitment fees paid prospectively or for commitment fees paid without regard to the amount borrowed. but to summarize the current state of deductibility for credit facility fees:

- **Unused Commitment Fees.** These fees should be currently deductible provided that they are determined on a retrospective unused amount of a total commitment.
- **Commitment Fees for Credit.** These fees should be deductible if the line of credit is not utilized but must be amortized over the life of the loan if the line of credit is utilized.
- **Facility fees.** The IRS has ruled that facility fees are currently deductible and are not treated as interest.
- **Upfront fees.** In contrast to unused commitment fees, commitment fees and facility fees, upfront fees are generally treated as reducing issue price.
- **Utilization fees.** These are generally fact dependent, as discussed above.

LAFAs may not be cited as precedent for a position[10] and it is unclear as to whether reliance on a LAFA satisfies the "substantial authority" standard to avoid penalties.[11] Nonetheless, the analysis set forth in the Advice builds a substantial body of law and seems sound. Accordingly, the use of unused commitment fees and other deductible fees as a method to compensate lenders for the extension of credit should constitute a sound strategy for avoiding the new limitations on the deduction of interest imposed by Code § 162(j).

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Endnotes

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2 For an overview of the Tax Cuts and Jobs Act's main provisions, please see "The Good, the Bad and the Ugly—Fundamental Tax Reform Is Enacted Into Law."

3 LAFA 20182502F (June 22, 2018).

4 *See also* C.C.A. 201136022 (Sep. 9, 2011).

5 *See* Revenue Ruling 70-540, 1970-2 C.B. 101 (Situation 3); FSA 200037034 (Sep. 15, 2000).

6 *See* Rev. Rul. 81-161, 1981-1 CB 313 (loan commitment fee capitalized and amortized over loan term).

7 *See also* TAM 8543004; FSA 1482 (Dec. 29, 1994); GCM. 39434 (Oct. 25, 1985); GCM 38527 (Oct. 2, 1980).

8 *See e.g.* Revenue Ruling 73-559, 1973-2 C.B. 299 (fees paid by seller of loan with below-market interest to compensate purchaser for accepting such below-market interest treated as reduction to loan purchase price and not a fee).

9 March 3, 2000

10 Code 6110(k).

11 *See* Treas. Reg. § 1.6662-4(d)(3)(iii).