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Legal Update

IRS Requires Cost Capitalization for Lease Acquisition Expenses

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The issues regarding whether costs incurred in connection with asset gathering for a securitization must be capitalized and amortized over time or can be immediately deducted is not always clear. On January 31, 2020, the US Internal Revenue Service (the "IRS") released Chief Counsel Advice ("CCA") 202005019. The CCA addressed whether a financial institution (the "Taxpayer") could deduct or was required to capitalize excess markup and participation payments to purchase automobile and equipment leases, respectively.[2] As discussed in more detail below, the IRS concluded that the Taxpayer had to capitalize such payments under section 263 of the Internal Revenue Code and applicable regulations.

Background

The Taxpayer purchased automobile and equipment leases from third-party dealerships and manufacturers in the ordinary course of business. This process involved: (1) the Taxpayer entering into master agreements with the dealerships and manufacturers; (2) the dealerships and manufacturers entering into lease agreements with customers; and (3) the dealerships and manufacturers selling the leases to the Taxpayer. The master agreements between the Taxpayer and the dealerships acknowledged that the dealerships were not acting as agents of the Taxpayer in originating the leases.

The pricing structure for the equipment leases was simpler than those for the automobile leases. For equipment leases, the Taxpayer offered the manufacturer or vendor a set percentage applied to the equipment cost ("participation payment"). For automobile leases, the Taxpayer offered the dealerships: (1) a lease acquisition flat-fee (the tax treatment of which was not an issue in the CCA); and (2) a premium on leases with an excess lease rate ("excess markup payment"). If the dealership negotiated a lease rate over a certain percentage rate, the Taxpayer would pay an excess markup payment to the dealership.

For book purposes, the Taxpayer capitalized and amortized the excess markup and participation payments. For tax purposes, however, the Taxpayer deducted its excess markup payments. The Taxpayer had a hybrid tax accounting method for the participation payments under which it capitalized and

amortized participation payments exceeding a certain dollar amount and deducted any participation payments below a certain dollar amount under its current method of accounting.

Applicable Law

In general, a taxpayer is allowed to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.[3] This rule is subject to certain exceptions, including rules that taxpayers must capitalize expenditures to acquire, create, or enhance separate and distinct assets, including acquisition costs for not only the asset itself but also for ancillary transaction costs incurred in the process of acquisition.[4]

The IRS issued regulations in 2003 addressing cost capitalization in order to reduce disputes between taxpayers and the IRS concerning whether particular costs were sufficiently related to the acquisition, creation, or enhancement of an intangible asset.[5] Under these regulations, taxpayers must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transactions.[6] A "lease" is specifically listed as an intangible within the scope of the rule.[7]

CCA Application of Law to Fact

In CCA 202005019, the IRS concluded that the Taxpayer had to capitalize, and not deduct, both the excess markup payments and the participation payments because they were direct costs to acquire intangible assets: the automobile and equipment leases. The IRS added that even if the Taxpayer successfully argued that the transactions did not constitute the acquisition of intangible assets, the excess markup payments and the participation payments would be considered as amounts paid to create an intangible asset and would therefore have to be capitalized.[8]

The Taxpayer argued that: (1) there was no sale of an intangible asset for tax purposes because the automobile dealership was acting as an intermediary to assign the leases to the Taxpayer; and (2) the excess markup payments and the participation payments represent compensation to the dealerships and manufacturers because they did not comprise or equate to the principal value of the contracts. The IRS dismissed the former because the master agreements specifically stated there was no agency relationship between the Taxpayer and the dealerships, and the IRS dismissed the latter because the Taxpayer provided no evidence to support that the excess markup payments and the participation payments were anything other than acquisitions of leases.

Observations

Lease securitizers not already capitalizing costs are likely to be impacted by the IRS's position in CCA 202005019. If an equity tranche is held by the securitizer, then the excess payments made to the lease originators should be recovered as amortization deductions over the life of the lease. The additional basis resulting from payments to lease originators can be recovered as gain or loss, if and when equity tranches in the securitization are sold. If the equity tranches are held as inventory, then the resulting gain or loss should be ordinary in character. On the other hand, if the equity tranches are considered capital assets in the hands of the securitizer, then any resulting gain or loss should be considered capital gain or loss.

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Endnotes

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[2] CCA 202005019.

[3] *See* IRC section 162.

[4] *See, e.g.*, *INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992); *Woodward v. Commissioner*, 397 U.S. 572 (1970); Treas. Reg. § 1.263(a)-4.

[5] *See* Treas. Reg. §§ 1.263(a)-4, 1.263(a)-5.

[6] *See* Treas. Reg. § 1.263(a)-4(c)(1).

[7] *See* Treas. Reg. § 1.263(a)-4(vi).

[8] *See* Treas. Reg. § 1.263(a)-4(d)(6).