

Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Taxpayer's
Address =
Brokerage Firm
=
Investment Plan
=
X =

ISSUES

- (1) Is a flat fee paid to a stockbroker for investment services a "carrying charge" under § 1.266-1(b)(1)(iv) of the Income Tax Regulations?

- (2) If the conclusion in Issue (1) is Yes, may Taxpayer elect to capitalize this flat fee to a capital account?

CONCLUSIONS

- (1) A flat fee paid to a stockbroker for investment services is not a carrying charge under § 1.266-1(b)(1)(iv).
- (2) Because our holding in Issue (1) is No, we do not address Issue (2).

FACTS

On September 10, 2001, Taxpayer and Brokerage Firm entered into a contract entitled "Investment Plan." Under this contract, Brokerage Firm agreed to act as a discretionary investment advisor and a custodian for the assets held in Taxpayer's account. Among other things, Brokerage Firm agreed to review and evaluate Taxpayer's investment objectives and to hire an unaffiliated manager ("Manager") to invest all or a portion of the assets in Taxpayer's account. In return, Taxpayer agreed to pay Brokerage Firm an annual fee of X percent of the market value of the assets in Taxpayer's account ("flat fee"). Payable at the beginning of each calendar quarter, the flat fee is a substitute for the following fees or charges otherwise payable by Taxpayer: (1) brokerage commissions payable to Brokerage Firm; (2) compensation payable to Taxpayer's Brokerage Firm financial consultant; (3) custodian charges payable to Brokerage Firm; and (4) a fee payable to the Manager of Taxpayer's account. On the year-end summary statement issued to Taxpayer, Brokerage Firm shows its quarterly withdrawals of the flat fee from Taxpayer's account. Each quarterly withdrawal is described as being for "Consulting and Advisory Services."

LAW

Section 266 of the Internal Revenue Code provides, in part, that no deduction shall be allowed for amounts paid or accrued for such carrying charges as, under regulations prescribed by the Secretary, are chargeable to capital accounts with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such charges as so chargeable.

Section 1.266-1(a)(1) of the Income Tax Regulations states that the items enumerated in paragraph (b)(1) of section 1.266-1 may be capitalized at the election of the taxpayer. Thus, carrying charges with respect to property of the type described in section 1.266-1(b) are chargeable to a capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of subtitle A of the Code. No deduction is allowable for any item so treated.

Section 1.266-1(b)(1) provides that the taxpayer may elect, as provided in paragraph (c) of section 1.266-1, to treat the items enumerated, which are otherwise expressly deductible under the provisions of subtitle A of the Code, as chargeable to a capital

account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purpose of section 1016(a)(1).

As illustrative of the items for which section 266 permits elective capitalization, section 1.266-1(b)(1)(iii) provides that in the case of personal property:

(a) Taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein,

(b) Interest on a loan to purchase such property or to pay for transporting or installing the same, and

(c) Taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

Finally, section 1.266-1(b)(1)(iv) states, in part, that any other carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to a capital account may be capitalized.

Section 1.266-1(b)(2) provides that the sole effect of section 266 is to permit the items enumerated in subparagraph (1) of section 1.266-1(b) to be chargeable to a capital account notwithstanding that such items are otherwise expressly deductible under the provisions of subtitle A of the Code. Section 1.266-1(b)(2) expressly provides that an item not otherwise deductible may not be capitalized under section 266.

Section 1.266-1(b)(3) cautions that in the absence of a provision in section 1.266-1 for treating a given item as a capital item, section 1.266-1 has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of section 1.266-1, and items which are otherwise treated as capital items are to be so treated. Similarly, an item not otherwise deductible is not made deductible by this section. Nor is the absence of a provision in this section for treating a given item as a capital item to be construed as withdrawing or modifying the right now given to the taxpayer under any other provisions of subtitle A of the Code, or of the regulations thereunder, to elect to capitalize or to deduct a given item.

ANALYSIS

Section 1.266-1(b)(1) permits a taxpayer to elect to capitalize a deductible expense if that expense qualifies under the applicable subcategory. The flat fee paid to Brokerage Firm does not qualify under any of the first three subcategories (*i.e.*, § 1.266-1(b)(1)(i), (ii), and (iii)), which concern (1) unimproved and unproductive real property; (2) real property, whether improved or unimproved and whether productive or unproductive; and

(3) [tangible] personal property. Furthermore, the flat fee does not qualify as a tax under the fourth subcategory (*i.e.*, § 1.266-1(b)(1)(iv)). Thus, Taxpayer may not elect to capitalize the flat fee under § 1.266-1(b)(1)(iv) unless the fee is an otherwise deductible “carrying charge” that in the Commissioner’s opinion is chargeable to a capital account under sound accounting principles. Therefore, assuming for the purposes of this analysis that a flat fee denoted “Consulting and Advisory Services” is deductible in the taxable year paid or incurred, we must decide whether it is a carrying charge and, if so, whether it is chargeable to a capital account under sound accounting principles.

The term “carrying charge” is not defined in § 266 or in its regulations, but definitions of similar terms appearing in §§ 163(b) and 263(g) suggest that carrying charges are expenses incurred when acquiring, financing, and holding property. For example, § 163(b) permits a buyer to claim an interest deduction at the rate of six percent when the total amount of the payments under an installment contract exceeds the purchase price of the property and the contract does not specify an annual rate of interest. In these instances, the excess of the total payments over the purchase price of the property is denoted “carrying charges,” and the amount of the taxpayer’s interest deduction may not exceed those carrying charges. Similarly, § 263(g) defines “interest and carrying charges” as the sum of interest on indebtedness incurred or continued to purchase or carry the personal property and all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property. Thus, under § 263(g) “carrying charges” are charges other than interest paid or incurred to carry personal property. See also Black’s Law Dictionary (8th Ed. 1999), which defines “carrying charge” as: (1) a cost, in addition to interest, paid to a creditor for carrying installment credit; and (2) expenses incident to property ownership, such as taxes and upkeep.

Although the Service has not ruled on what qualifies as a capitalizable carrying charge under § 1.266-1(b)(1)(iv), it has ruled on what qualifies as a capitalizable cost under related sections. For example, the Service ruled that undeveloped oil and gas leases are unproductive real property and that a lessee may elect to capitalize delay rentals because the payment of delay rentals extends the period in which the lessee may drill wells for the production of oil and gas. Rev. Rul. 55-118, 1955-1 C.B. 320. On the other hand, the Service ruled that advertising expense incurred for unproductive property and maintenance and upkeep costs attributable to improved unproductive real property and real property that is both unimproved and unproductive are not carrying charges. Rev. Rul. 71-475, 1971-2 C.B. 304. Finally, the Service ruled that direct reforestation costs, such as planting and artificial or natural seeding, are capital expenditures subject to depreciation, while indirect expenditures, such as interest paid on money borrowed to satisfy a state law requiring a deposit to guarantee natural reforestation over a specified period of years in lieu of planting, or a service charge on a performance bond in lieu of a cash deposit, may be treated as current deductions subject to an election under § 266. Rev. Rul. 75-467, 1975-2 C.B. 93. Moreover, in a case decided before the enactment of § 263A, the Tax Court held that margin interest is a carrying charge and that the taxpayer may not elect to capitalize margin interest under

§ 1.266-1(b)(1)(iv) because capitalizing interest to the basis of purchased stock does not accord with sound accounting principles. *Purvis v. Commissioner*, 65 T.C. 1165 (1976).

Other courts also have provided general guidance concerning whether a payment is an ordinary and necessary business expense or a capitalizable cost and, thus, whether an otherwise deductible expense should be capitalized under sound accounting principles. For example, reversing the Tax Court, one appellate court held that payments by a publisher to an independent contractor for the production of a manuscript are capitalized costs. *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982). A different appellate court sustained the Tax Court's determinations that monthly retainer fees paid for investment advisory services are currently deductible under § 212 but that a one-time fee paid only if the taxpayer invested in a limited partnership is part of the cost of acquiring that limited partnership interest (*i.e.*, a capitalized cost). *Honodel v. Commissioner*, 722 F.2d 1462 (9th Cir. 1984).

Considering the previously described provisions of the Code and regulations, revenue rulings, and court opinions, we believe that the flat fee denoted "Consulting and Advisory Services" is not a carrying charge under § 1.266-1(b)(1)(iv). This flat fee is not interest expense incurred under an installment contract. But even if it were, it would not be capitalizable under § 1.266-1(b)(1)(iv). *Purvis v. Commissioner, supra*. Fees for consulting and advisory services are better viewed as currently deductible investment expenses. *Honodel v. Commissioner, supra*. Consulting and advisory fees are not carrying charges because they are incurred independent of a taxpayer's acquiring property and because they are not a necessary expense of holding property. Stated differently, consulting and advisory fees are not closely analogous to common carrying costs, such as insurance, storage, and transportation. See, *e.g.*, § 263(b). Having decided that the flat fee denoted "Consulting and Advisory Services" is not a carrying charge, we find it unnecessary to decide whether it is chargeable to capital account under sound accounting principles.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



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Please call (202) 622-4970 if you have any further questions.

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