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TAX TREATMENT OF REORGANIZATION COSTS

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Tax Treatment of Reorganization Costs

OVERVIEW

- I. Deduction vs. Capitalization
 - A. Section 162(a) of the Internal Revenue Code allows a deduction for all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ."¹
 - B. Section 263, however, prohibits deductions for amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Such items must be capitalized.
 - C. The line between what items may be deducted and what items must be capitalized has long been a question for debate in the tax field. See Thompson v. Commissioner, 9 B.T.A. 1342 (1928) (holding that expenditures for surveys, geological opinions, legal opinions, settlements of suits involving title to lands, and abstracts of title are not deductible as ordinary and necessary expenses, but are capital expenditures to be added to cost of property).
- II. In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), the Supreme Court held that expenditures incurred by a target corporation in the course of a friendly takeover are nondeductible capital expenditures.
- III. Although INDOPCO clarified the law as it pertains to target corporations in successful friendly takeovers, issues still remain regarding the deductibility of expenses related to the investigation of an acquisition, expenses related to failed or abandoned transactions, expenses related to fighting hostile takeovers, expenses related to searching for white knights, expenses related to divisive reorganizations, expenses related to proxy fights, and costs of obtaining financing to redeem shares to prevent a hostile takeover, among others. This outline addresses those issues.
- IV. This outline also addresses the final regulations under section 263(a) (the "Final Regulations"), T.D. 9107 (December 31, 2003), which, among other things, are intended to clarify and simplify many of these issues and should diminish the applicability of much of the case law and IRS authorities discussed in this outline. See generally Treas. Reg. §§ 1.263(a)-4 and -5.
 - A. The Final Regulations provide bright-line rules that govern taxpayers' treatment of three different types of costs, including:

¹ All Code sections refer to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise noted.

1. Amounts paid to acquire or create intangibles;
 2. Amounts paid to facilitate the acquisition or creation of intangibles; and
 3. Amounts paid to facilitate a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.
- B. This outline primarily concerns the third-type of cost -- amounts paid to facilitate a restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization. However, for the sake of clarity and completeness, this outline also will briefly discuss the Final Regulations that govern the amounts paid for the acquisition or creation of intangibles and the amounts paid to facilitate the acquisition or creation (i.e., the first and second type of cost).
- V. Accordingly, PART ONE of this outline discusses the present law (i.e., statutes, case law, and relevant IRS authorities) applicable to the determination of the treatment of reorganization costs. PART TWO of this outline discusses the Final Regulations as they relate to this determination.

PART ONE -- THE PRESENT LAW

I. COSTS FOR UNCONTESTED ACQUISITIONS

A. Costs Incurred by Target Corporations: National Starch and INDOPCO

1. Early Revenue Rulings

- a. In Rev. Rul. 67-125, 1967-1 C.B. 31, the Internal Revenue Service ("Service") held that legal fees for advice as to the tax significance of a potential reorganization must be capitalized.
 - (i) The Service noted first that legal fees incurred for services performed in drafting a merger agreement must clearly be capitalized as incident to a reorganization, since the merger changes the capital structure of the corporation. Rev. Rul. 67-125, supra.
 - (ii) The Service went on to explain that legal fees for advice as to the tax ramifications of such reorganization are "just as necessary in effecting a reorganization as those for the actual drafting of the reorganization agreement." Id.
- b. In Rev. Rul. 73-580, 1973-2 C.B. 86, the Service held that compensation paid for services performed by employees relating to reorganizations should be treated the same as fees paid for similar services performed by outsiders. Thus, under the analysis set forth

in Rev. Rul. 67-125, *supra*, the portion of compensation paid to employees in connection with services relating to a reorganization must be capitalized.

2. National Starch

- a. In National Starch and Chemical Corp. v. Commissioner, 918 F.2d 426 (3rd Cir. 1990), aff'g 93 T.C. 67 (1989), aff'd INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), the Third Circuit, in affirming a Tax Court decision, held that a corporation must capitalize consulting fees, legal fees and other expenses incurred in deciding whether to accept a friendly takeover bid.
- (i) Unilever, the acquirer, was a United States company that was owned by a foreign company. Wanting to increase its United States revenues relative to its overall revenues, the foreign company directed Unilever to approach National Starch, one of Unilever's suppliers, to find out if National Starch would be interested in being the target of a friendly takeover. Unilever made it clear that they were only interested in a friendly takeover.
 - (ii) To accommodate the principal shareholders of National Starch, the transaction was consummated in two steps.
 - (a) In step one, shareholders of National Starch were given the opportunity to exchange each share of National Starch common stock for one share of nonvoting preferred stock of a newly formed subsidiary of Unilever. This transaction was intended to be tax free under section 351.²
 - (b) In step two, a transitory subsidiary of the Unilever subsidiary was merged into National Starch, and any National Starch common stock not exchanged under step one was converted into cash (a "reverse subsidiary cash merger").
 - (iii) National Starch hired independent investment bankers and attorneys to assist in valuations and to make sure the board of directors did not breach any fiduciary duties. In addition, National Starch incurred miscellaneous fees such as accounting, printing, proxy solicitation, and SEC fees in connection with the transaction. National Starch deducted

² In the transaction, 179 of National Starch's shareholders, holding approximately 21% of National Starch's common stock, exchanged their shares for shares in the Unilever subsidiary.

these fees, but the Service argued that they should be capitalized.

- b. National Starch argued that the Supreme Court's holding in Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971) established a rule that an expense is only a capital expense if a separate and distinct additional asset has been created or enhanced due to the expense.
 - (i) Since there was no separate asset created under the merger, National Starch argued, the fees should not be capitalized. Thus, the corporation should be allowed to deduct the expenses under section 162(a).
 - (ii) Furthermore, National Starch argued that Lincoln Savings specifically rejected looking to the presence of a future benefit to determine whether expenditures were ordinary and necessary.
- c. The Tax Court and Third Circuit in National Starch, however, disagreed with these arguments. The Third Circuit noted that Lincoln Savings did not establish a "separate and distinct asset" test, and that it is possible for an expense to be a capital expense, even though there is no separate and distinct asset.
 - (i) Although the court stated that no one factor controls the deduction/capitalization distinction, the Third Circuit seemed to adopt a "future benefits" test.
 - (ii) Under this test, an expense must be capitalized if such expense would produce benefits for the future. Whether or not an expense will produce a future benefit is a question of fact.
 - (iii) Note: The future benefits test is not a new one. Courts have recognized in the past that expenses like those above "incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses." General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964) (quoting Farmers Union Corp. v. Commissioner, 300 F.2d 197 (9th Cir. 1962)). See Mid-State Products Co. v. Commissioner, 21 T.C. 696 (1954) (disallowing deductions for attorneys fees because reorganization expenses result in continuing benefit to successor corporation).

3. INDOPCO

- a. The Supreme Court in INDOPCO, Inc. v. Commissioner affirmed the Third Circuit's decision in National Starch.³ The Court held that the fees noted above "produced significant benefits to National Starch that extended beyond the tax year in question" INDOPCO, at 88. Thus, they must be capitalized.
- (i) The Court held that the fact that the fees do not create or enhance a separate and distinct additional asset under Lincoln Savings "is not controlling." INDOPCO, at 90. Lincoln Savings did not hold that only expenditures that create or enhance separate and distinct assets are to be capitalized, just that those that do must be capitalized. The INDOPCO court concluded that investment banker fees, legal fees, proxy costs, and S.E.C. fees incurred by a target corporation in a friendly takeover must be capitalized if the takeover produces significant future benefits.
 - (ii) Regarding the future benefits test, the Court stated that "although the mere presence of an incidental future benefit . . . may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important" in determining whether the costs must be capitalized. INDOPCO, at 87.
 - (iii) Thus, it appears that the Supreme Court did not literally establish a future benefits test. Rather, they provided only that such a benefit is "undeniably important" in determining whether an expenditure must be capitalized. Subsequent cases, however, use future benefits as the benchmark in determining whether an expense may be deducted. See, e.g., Victory Markets, Inc. v. Commissioner, 99 T.C. 648 (1992); A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166 (1995), rev'd 119 F.3d 482 (7th Cir. 1997).
 - (iv) Note: The Southern District of Ohio in In re Federated Dep't Stores, Inc., 171 Bankr. 603, 94-2 U.S.T.C. ¶ 50,430 (S.D. Ohio 1994), concluded that INDOPCO does not stand for the proposition that any expenditure "that merely preserves the existing corporate structure or policy must be capitalized." As a threshold issue, costs must be incurred in connection with the reorganization for the rules under INDOPCO to apply. See United States v. Gilmore, 372 U.S. 39 (1963). See also Pope & Talbot, Inc. v.

³ Prior to the Supreme Court's decision, National Starch and Chemical Corporation changed its name to INDOPCO, Inc.

Commissioner, 162 F.3d 1236 (9th Cir. 1999), aff'g 73 T.C.M. 2229 (1997) (holding that fees paid for business planning and advice as to potential corporate acquisitions were deductible because no acquisition or takeover was ever threatened or attempted); Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000) (holding that costs incurred in the investigation of whether to be acquired are deductible if such costs are incurred prior to a final decision regarding the approval of the transaction for submission to the shareholders).

- (a) Thus, in TAM 9402004 (Sep. 10, 1993), the Service ruled that costs incurred by a target corporation related to acquiring five years of liability insurance for claims against the target's officers and directors, which insurance was required by the acquirer prior to purchase, were immediately deductible. Although the target's normal business practice was to purchase insurance on a yearly basis, the Service argued that such insurance costs would have been incurred by the target eventually, whether the merger went through or not.
 - (b) Furthermore, in TAM 9641001 (May 31, 1996), the Service concluded that premiums paid to debt holders in repurchasing their debt, in order to obtain the shareholders' consent to a merger, were not a capital expenditure. The Service reasoned that the early retirement of the debt was not an integral part of the merger, but payment on an already existing debt. The corporation was not required to purchase the debt as part of the merger. However, the Service ruled that consent solicitation payments to the shareholders must be capitalized, as such payments had their origin in the merger.
- b. The Service has stated that it believes that the decision in INDOPCO "did not change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized." See Notice 96-7, 1996-1 C.B. 359. Furthermore, the Service has ruled that INDOPCO did not alter the deductibility of advertising costs (Rev. Rul. 92-80, 1992-2 C.B. 57), incidental repair costs (Rev. Rul. 94-12, 1994-1 C.B. 36), severance payments (Rev. Rul. 94-77, 1994-2 C.B. 19), training costs (Rev. Rul. 96-62, 1996-2 C.B. 9; PLR 199918013 (training costs associated with building a workforce for a new division are

deductible)), or voluntary certification costs (Rev. Rul. 2000-4, 2000-1 C.B. 331).

- (i) All of the above are generally deductible under section 162, even though they may have some future effect on business activities. See RJR Nabisco Inc. v. Commissioner, TC Memo 1998-252 (1998) (RIA) (holding that there is no distinction between the costs of developing advertising campaigns and the costs of executing those campaigns, and thus the former are deductible, regardless of the fact that expenditures for the development of advertising campaigns give rise only to long-term benefits). However, in certain circumstances such costs must be capitalized. For example, if advertising is directed towards obtaining future benefits "significantly beyond those traditionally associated with ordinary product advertising," a taxpayer must capitalize the advertising costs. Rev. Rul. 92-80, supra; In re Hillsborough Holdings Corp., 85 AFTR 2d. 2000-1818 (Bankr. M.D. Fla. 3/30/2000) (denying deduction for advertising and printing expenses in connection with the offers to purchase the target); PLR 199952069 (denying deduction for travel costs associated with the solicitation of new business).
- (ii) At least one Circuit Court has affirmed the Service's position that INDOPCO maintains the fundamental legal principles for determining whether an expenditure may be deducted or must be capitalized. See PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822 (3rd Cir. 2000), rev'g 110 T.C. 349 (1998). In PNC Bancorp, Inc., the Third Circuit concluded that the INDOPCO holding does not require costs that have been historically deductible, such as loan origination fees, to be capitalized. On appeal from the Tax Court, the Service argued that the Tax Court was correct in requiring the capitalization of loan origination fees as they created a separate and distinct asset under Lincoln Savings. The Third Circuit, however, determined that "the Tax Court took too broad a reading of what Lincoln Savings meant by separate and distinct" and held that loan origination fees were deductible under section 162 because such expenses were ordinary and "geared toward income production" rather than "betterment[s] into the indefinite future." But see Lychuk v. Commissioner, 116 T.C. 374 (2001) (disagreeing with the Third Circuit's holding in PNC Bancorp, Inc. with respect to the deductibility of loan origination fees); FSA 200109001 (Mar. 3, 2001) (disagreeing with the holding expressed in PNC Bancorp,

Inc. and stating that a corporation is required to capitalize the costs of acquiring loans).

4. Payments to Employees Terminating Unexercised Stock Options

- a. Corporations that are acquired in reorganizations often must make payments to employees holding unexercised stock options, in order to facilitate the transaction.
- b. In Rev. Rul. 73-146, 1973-1 C.B. 61, the Service held that payments to target employees to terminate unexercised stock options, as a condition of a reorganization, are compensation to the employees, and deductible by the corporation.
 - (i) The Service ruled that the cancellation of the options was not in satisfaction of a new obligation generated by the reorganization, but in satisfaction of a pre-existing obligation of a compensatory nature.
 - (ii) Thus, payment to employees was deductible as an ordinary and necessary business expense under section 162. See TAM 9438001 (Apr. 21, 1994) (acquiring corporation purchases stock options from target employees indistinguishable from Rev. Rul. 73-146).
- c. Another issue arises as to amounts paid to employees to terminate unexercised stock options that are in excess of amounts that would have been paid to the employees had a pending takeover not influenced the stock price.
 - (i) In TAM 9540003 (June 30, 1995), the Service addressed this issue in the context of both stock options and stock appreciation rights.
 - (ii) The Service held that such payments "are substantially the same as the payments that were analyzed by the Service in Rev. Rul. 73-146."
 - (iii) Although the agent contended that the excess amount over the amount that would have been paid to employees barring the pending takeover should be capitalized, the Service stated that such a distinction is not controlling.
 - (a) The Service noted that such a premium may have been present in Rev. Rul. 73-146, supra.
 - (b) In addition, the premium was merely the fair market value of the stock at that time, and compensation to

the employee would rise along with the fair market value.

- (c) The Service also noted that a deductible expense is not converted to a capital expenditure solely because the expense is incurred as part of a reorganization.
 - (iv) In FSA 199201244, 99 ARD 195-1 (Jan. 24, 1992), the taxpayer corporation made payments pursuant to employee phantom stock plans. Although the value of the stock was influenced by a pending takeover and a self-tender offer, the Service held the payments to be compensatory in nature and, therefore, deductible.
- d. As opposed to the above rulings, in Jim Walter Corp. v. United States, 498 F.2d 631 (5th Cir. 1974), the Fifth Circuit held that a corporation could not deduct an amount paid to repurchase warrants.
- (i) The exercise of a warrant entitled the holder to one share of common stock and two \$25, 9% subordinated bonds.
 - (ii) The corporation in Jim Walter wanted to repurchase the warrants because they were conducting a separate public offering of securities, and the underwriters of the offering feared that the warrants might be exercised, thus causing the issuance of substantial debt obligations and shares of common stock, resulting in large interest payments and a serious dilution of shareholder equity and earnings per share.
 - (iii) The Jim Walter court stated that the repurchase of warrants was a recapitalization expense associated with the public offering, and held that expenses incurred in connection with the acquisition or issuance of corporate stock are nondeductible capital expenditures.
 - (iv) The court implied that it might reach a different result if the repurchase of the warrants were necessary for the corporation's survival.
 - (v) Although the Jim Walter decision seems contrary to Rev. Rul. 73-146, supra, taxpayers presumably should be allowed to follow the Service's guidance and deduct costs related to payments to employees to terminate unexercised stock options and warrants.

5. Pre-Acquisition Investigatory Costs

- a. In Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000), rev'g in part Norwest Corporation and Subsidiaries v. Commissioner,⁴ 112 T.C. 89 (1999), the Eighth Circuit held that INDOPCO does not require capitalization of pre-acquisition investigatory and due diligence costs that are ordinary, related to the carrying on of an existing trade or business, and incidentally connected with a future benefit.
- (i) In Wells Fargo, the target bank hired both a financial consulting firm and a law firm in order to determine whether a merger with another bank would benefit the company and the community. The target also directed that board members and several high ranking officers devote time to considering the merits of the transaction. On July 22, 1991, the Board voted to recommend the transaction to the shareholders. The target bank deducted expenses incurred both before and after the date of the Board's approval of a recommendation to submit the transaction to the shareholders.
 - (ii) The Eighth Circuit held that the portion of officers' salaries attributable to services performed in the transaction was fully deductible, reasoning that the payments for services arose out of, and were directly related to, an employment relationship and were only indirectly related to the acquisition. The court found that expenses attributable to employee compensation are traditionally deductible and held that "paying salaries to corporate officers is a transaction of common or frequent occurrence in the business world." 224 F.3d at 886 (internal quotations omitted).
 - (iii) The Court also held that costs properly attributable to the investigatory stage of a transaction are only indirectly related to the future benefits derived from the consummation of the transaction and, therefore, currently deductible.
 - (a) The Court held that the investigatory stage of the transaction ended, and a "final decision" regarding the transaction was reached, when the parties

⁴ Norwest was acquired by Wells Fargo prior to the Eighth Circuit's decision in Wells Fargo.

entered into an Agreement and Plan of Reorganization.

- (b) However, the Court also held that “[o]ur determination on this point is not to be construed as a ‘bright line rule’ for determining when a ‘final decision’ has been made. The facts and circumstances of each case must be evaluated independently to make a proper finding on that issue.”

b. Prior to the Wells Fargo decision, the Service acquiesced to the deductibility of a portion of the investigatory costs conceding that Rev. Rul. 99-23, 1999-1 C.B. 998, (discussed below) mandated such a result. Accordingly, The Government’s Response Brief stated that “such costs are deductible where, as here, the cost is incurred by a taxpayer already actively engaged in an existing trade or business in the same field as the trade or business with respect to which the investigatory costs are incurred.” Government’s Response Brief, 224 F.3d 874 (8th Cir. 2000) (No. 99-3307); See also Salem & Shaw, Deducting Business Expansion Costs: IRS Opens a Window on the *INDOPCO* Door, Mergers & Acquisitions Vol. 1, No. 2, at 23 (June 2000) (summarizing the appellate pleadings in Norwest) (hereinafter Deducting Business Expansion Costs).

- (i) In Rev. Rul. 99-23, which technically applies only to start up costs incurred by an acquiring corporation under section 195, the Service defined investigatory costs as the costs incurred in determining whether to acquire a business and which business to acquire. Under Rev. Rul. 99-23, once these decisions have been made, all further expenses are properly attributable to facilitating the consummation of that acquisition rather than investigating the acquisition. Pre-decision expenses are amortizable under section 195 whereas post-decision expenses must be capitalized under section 263.

- (ii) Rev. Rul. 99-23 and the Wells Fargo holding suggest that the dividing line between “investigating” and “carrying out” an acquisition is a “final decision” to go forward with the transaction: pre-final decision expenses may be deductible (or amortizable in the case of start-up expenses), post-decision expenses may not be deductible. The final decision is made once the acquiring corporation has determined whether to acquire a trade or business and which trade or business to acquire. Further, the

determination of when a decision has become final is based upon an evaluation of the independent facts and circumstances of each case.

6. Summary

Fees incurred by a target corporation in a friendly takeover must generally be capitalized, as such takeovers usually produce significant long-term benefits. While the INDOPCO court did not explicitly adopt a "future benefits" test, most courts have used such a test in determining whether a taxpayer must capitalize costs incurred in reorganizations. Pre-transaction investigatory costs are generally deductible if the costs are properly attributable to the determination of whether to acquire a new business and which business to acquire. In addition, payments to employees terminating unexercised stock options in order to facilitate a reorganization are generally deductible under section 162.

B. Costs Incurred by Acquiring Corporations

1. Although INDOPCO technically only applied to costs of a target corporation pursuant to a reorganization, the principles of the case apply to the acquisition costs of acquirers. See In re Hillsborough Holdings Corp., supra (relying, inter alia, on INDOPCO to disallow the acquirer's acquisition-related fees and costs).
2. In United States v. Hilton Hotels Corp., 397 U.S. 580 (1970), the Supreme Court held that litigation expenses incurred by an acquirer in connection with the valuation of stock due to a hotel merger were capital expenditures rather than business deductions.
 - a. In Hilton, the acquirer hired a consulting firm to prepare a merger study to determine a fair rate of exchange of stock. However, the target's dissenting shareholders disagreed with the consulting firm's result, and began appraisal proceedings following the merger. The acquirer deducted fees paid to the consulting firm for the merger study, and the cost of legal and professional services arising out of the appraisal proceeding.
 - b. The Court reasoned that expenses of litigation arising out of the acquisition of a capital asset are capital expenses. They further stated that the primary purpose of the transaction is not relevant to such determination.
 - (i) In Woodward v. Commissioner, 397 U.S. 572 (1970), a companion decision to Hilton, the Court noted that a test based upon the taxpayer's purpose in undertaking litigation "would encourage resort to formalisms and artificial

distinctions." See also Jim Walter, *supra* (agreeing with the court's reasoning in Woodward).

- (ii) Thus, if litigation expenses are directly related to the purchase of stock, such expenses must be capitalized.
3. Litigation expenses incurred to defend shareholder objections to a merger must be capitalized. Berry Petroleum v. Commissioner, 142 F.3d. 442 (9th Cir. 1998), *aff'g* 104 T.C. 584 (1995). In Berry Petroleum, a corporation acquired the stock of a target, and the minority shareholders of the target brought a lawsuit against the acquirer alleging that the merger caused the target minority shareholders irreparable damage. The acquirer attempted to deduct the litigation expenses associated with the suit as ordinary and necessary business expenses. The Ninth Circuit affirmed the Tax Court's ruling that the suit had its origins in the corporation's acquisition of stock, and the costs to defend that suit are not deductible as ordinary and necessary business expenses.
 - a. The "origin and character" test for determining whether litigation expenses can be deducted was applied in In re Hillsborough Holdings Corp., *supra*. At issue in In re Hillsborough Holdings Corp. was a leveraged buyout which a group of shareholders sought to enjoin. The court directed its inquiry to "the ascertainment of the kind of transaction out of which the litigation arose." Because the origin of the litigation was the disposition of the target stock, the expenses of settling the litigation were nondeductible.
4. Retainer fees paid annually to a law firm to ensure that such firm would not represent hostile companies are not deductible to the extent such fees are offset against fees for legal services associated with a capital transaction. Dana Corporation v. United States, 174 F.3d 1344 (Fed. Cir. 1999), *rev'g* 38 Fed. Cl. 356 (1997). The origin of the retainer is determined by the services provided during the year it was paid.
5. Legal fees incurred defending against a state antitrust suit which arose from the acquisition of a company are not deductible. American Stores Co., et al. v. Commissioner, 114 T.C. 458 (2000). In American Stores, an affiliated group of retail food and drug corporations purchased a chain of grocery stores. Even though the merger was approved by the FTC, the state of California objected and filed an antitrust suit to block the merger. While the suit was pending, the companies were prevented from combining their business operations. Citing INDOPCO, the court concluded that the legal services at issue were "performed in the process of effecting a change in corporate structure for the benefit of future operations," and not in the process of defending existing operations. For

this reason, the costs of creating the new corporate structure, including the legal fees, had to be capitalized.

6. Accounting fees paid by an acquiring company to investigate the financial condition of a target, incurred in connection with the acquisition of such target's stock, also must be capitalized. Ellis Banking Corp. v. Commissioner, 688 F.2d 1376 (11th Cir. 1982). The Ellis Banking court held that "expenses of investigating a capital investment are properly allocable to that investment and must therefore be capitalized." Id., at 1382. See also In re Hillsborough Holdings Corp., supra (holding that fees and costs incurred to evaluate offers to purchase target stock, as well as fees paid in connection with analyzing the target's potential environmental liability are nondeductible). But see Wells Fargo, supra (implying that such fees are deductible if incurred prior to determining whether and/or which target to acquire).
7. Advertising expenditures incurred for the predominant purpose of facilitating the acquisition of a capital asset are not deductible. See Rev. Rul. 92-80, supra; In re Hillsborough Holdings Corp., supra (denying deduction for advertising and printing expenses in connection with the offers to purchase the target).
8. In TAM 9825005 (Mar. 9, 1998), the Service ruled that a bank holding company's expenditures in investigating the acquisition of a bank must be capitalized and are not eligible for amortization under section 195. The Service reasoned that the expenditures were not start-up costs, but acquisition costs. But see Rev. Rul. 99-23, supra (discussed below).
9. Although many of the above authorities indicate that all expenditures related to a reorganization must be capitalized, courts and the Service have permitted the deduction of reorganization-related expenses under certain circumstances.
 - a. In Rev. Rul. 99-23, supra, the Service clarified that investigatory expenditures incurred by a taxpayer in the course of a general search for, or investigation of, an unrelated active trade or business (in order to determine whether to enter a new business or which existing business to acquire) qualify as start-up costs amortizable under section 195.
 - (i) For example, costs incurred to conduct industry research and review public financial information about a trade or business that is unrelated to the trade or business of the acquiring company are amortizable under section 195 because they are related to a general investigation of the acquisition of a new trade or business. See Rev. Rul. 99-23, Situation 1. Legal fees related to the "preliminary due

diligence” services prior to the time the acquirer makes the decision to acquire the target involved in an unrelated trade or business are also amortizable under section 195. Id., Situation 3. Costs incurred to evaluate the target and the target’s competitors also may be amortizable investigatory costs, but only to the extent they were incurred to assist the acquirer in determining whether to acquire an unrelated business and which unrelated business to acquire. Id., Situation 1.

- (ii) By contrast, costs incurred in an attempt to acquire a specific unrelated trade or business are capital in nature and, thus, are not characterized as start-up expenditures. For example, costs incurred to draft regulatory approval documents for a target are not amortizable even if incurred prior to the time the acquirer makes a final decision to acquire the target, because the purpose of such costs is to facilitate the acquisition. See Rev. Rul. 99-23, Situation 2. Due diligence costs incurred after the decision to acquire a specific business must be capitalized. Id., Situation 3.

- b. In Wells Fargo, supra, which technically applies to a target’s costs, the Eighth Circuit applied and extended the Service’s conclusions in Rev. Rul. 99-23, holding that investigatory costs (“whether” and “which” expenses) were deductible under section 162. The court further held that employee salaries associated with the potential acquisition of a related trade or business were deductible because they were ordinary and only indirectly related to the long term benefits derived from the acquisition.
- c. In Rev. Rul. 67-408, 1967-2 C.B. 84, an acquirer became obligated to pay severance payments to employees of a target who were terminated due to the merger. The acquirer was obligated to pay such amounts due to agreements with railroad unions, in order to facilitate the merger. The Service ruled that the satisfaction of the acquirer's obligation constituted ordinary and necessary business expenses that are deductible under section 162. The payments would not have been made but for the prior employment relationship between the target and the employees.

- d. In TAM 9326001 (March 18, 1993), a target had severance payment provisions in contracts with officers that provided payments to such officers in the event the officers were terminated as a result of a merger.
- (i) Following a merger, the acquiring corporation entered into new agreements with the officers that had approximately the same provisions as in the old agreements. The officers were then terminated prior to the expiration of the new agreements, and the acquirer paid the amounts designated in the new agreements.
 - (ii) The Service ruled that the acquirer could deduct the amounts paid to the officers, because the payments related to the employment relationship, not the reorganization. The payments were merely coincidental to the reorganization, as they "had their basis in the longstanding employment relationship with [the target], not the reorganization itself." TAM 9326001 (Mar. 18, 1993).
- e. See also PLR 9527005 (Mar. 15, 1995) (ruling that amounts paid as "bonuses" to make up for terminated stock options are deductible, as such amounts arise in the employment relationship); PLR 9721002 (Jan. 24, 1997) (ruling that severance payments made following a section 338 acquisition are deductible); PLR 9731001 (Jan. 31, 1997) (ruling that severance payments made under an agreement of merger that are more than payments normally required under a pre-merger plan are deductible as such payments are coincidental to the merger).
- f. Expenditures for goodwill associated with the acquisition of a business may be deducted provided that the expenditures reflect "economic reality." In C.H. Robinson v. Commissioner, T.C. Memo 1998-430, a corporation acquired the assets of another corporation, including a covenant not to compete and the employment services of a key officer. The purchase price consisted of a \$300,000 cash payment, \$1.3 million for a three-year covenant not to compete, a \$250,000 per year bonus payment to a key officer, and \$292,000 per year as additional payments under the covenant not to compete. The corporation claimed the payments for the covenant and the salary bonuses were ordinary and necessary business expenses. The Tax Court ruled that the \$300,000 cash payment and the \$1.3 million payment for the covenant were payments for the company's assets, and therefore not deductible. The court reasoned that these payments resembled

the original terms of the agreement to purchase the assets. The additional payments of \$292,000 associated with the covenant not to compete were allowed as deductions because they “reflected economic reality” in that a threat of competition was feasible. The Tax Court also held that the bonus payments were deductible because they constituted reasonable compensation.

- g. In Metrocorp, Inc. v. Commissioner, 116 T.C. 211 (2001), the Tax Court allowed a bank to deduct fees paid to FDIC insurance funds upon acquisition of a failed savings association because the fees were regular business costs and produced no significant future benefit to the bank that would require capitalization, and the Service did not argue that the fees were incurred in connection with the acquisition of a business.

10. Summary

Expenses incurred by an acquirer pursuant to a friendly takeover must generally be capitalized. However, such expenses may be deducted if they relate to the pre-final decision investigation of whether to acquire a business and which business to acquire, are incurred due to a prior employment relationship.

C. Costs Incurred by Shareholders

1. The authorities that relate to costs incurred by shareholders conclude that reorganization costs must be capitalized. While INDOPCO is not specifically applied in these cases, the analysis appears to be much the same.
2. In Woodward v. Commissioner, 397 U.S. 572 (1970), the shareholders of a corporation were required by state law to purchase the interest of dissenting shareholders who did not agree with a change in the corporation's charter. The non-dissenting and dissenting shareholders could not agree on a price for the purchase of such shares. Thus, the non-dissenting shareholders brought an action to appraise the value of the stock.
 - a. In holding that the litigation expenses must be capitalized, the Supreme Court stated that the origin of the claim was founded in the purchase of stock, a capital event. The litigation expenses were part of the process of acquisition.
 - b. The holding in Woodward also applies to costs incurred by minority shareholders who incur legal fees to appraise their minority stock interest. In Third National Bank v. United States, 427 F.2d 343 (6th Cir. 1970), the court held that the Supreme

Court in Woodward "clearly intended" its ruling to apply to sellers of stock in addition to purchasers of stock.

3. Furthermore, Rev. Rul. 67-411, 1967-2 C.B. 124, makes clear that brokerage, legal, accounting, and related expenses of a target corporation which are paid by its shareholders pursuant to a "C" reorganization must be capitalized by such shareholders and are not deductible under section 212. The shareholders increased their basis in the stock acquired pursuant to the reorganization.
4. Note: If the corporation pays the expenses of selling shareholders, such payment may result in a constructive distribution to the shareholders. See FSA 199304292 (Apr. 29, 1993) (holding that if the benefit to the corporation is outweighed by the benefit to the shareholders, payment of selling shareholder expenses by the target corporation may result in a constructive distribution to the selling shareholders).
5. Costs may be deducted, however, if they are not related to a reorganization.
 - a. In Picker v. United States, 371 F.2d 486 (Ct. Cl. 1967), shareholders of a closely held corporation hired investment counselors to help diversify their investments.
 - b. Although the investment counselors did suggest that the shareholders merge their company with a listed company, the shareholders found a company on their own and merged without the help of the investment counselors.
 - c. The Claims Court in Picker held that the purpose of hiring the investment counselors was to improve the shareholders' capacity to produce income. Thus, their fees were deductible under section 212, since the services rendered were either unrelated to the eventual merger or related only to abandoned transactions.
6. Personal Guarantees
 - a. Personal guarantees by shareholders given to acquiring corporations in order to facilitate a merger must also be capitalized if ultimately paid.
 - b. In Estate of McGlothin v. Commissioner, 370 F.2d 729 (5th Cir. 1976), a shareholder of a target corporation guaranteed an acquiring corporation that property would yield a minimum amount of profits within two years. When such property did not yield the minimum amount, the shareholder was required to pay the acquiring corporation the guaranteed amount.

- c. The court held that the shareholder must capitalize the amount paid as part of the guarantee because it was part of the purchase price of the acquiring company's stock. Estate of McGlothin v. Commissioner, 370 F.2d 729 (5th Cir. 1976). In essence, the shareholder received the acquiring company's stock in exchange for target stock plus the guarantee. Thus, the guarantee was part of the cost of acquisition of a capital asset.

7. Summary

Expenses incurred by shareholders in connection with a reorganization must generally be capitalized. Furthermore, personal guarantees given by shareholders of a target to an acquiring corporation in order to facilitate a reorganization must be capitalized if paid. Based on the foregoing, it seems likely that future decisions related to expenses incurred by shareholders pursuant to a reorganization will cite INDOPCO, and reach a similar result.

D. Public Comments on INDOPCO

1. In January of 1996, the Service invited the public to comment on the approaches it should consider in addressing issues under section 162 and section 263 in light of INDOPCO. Notice 96-7, 1996-1 C.B. 359 (Jan. 18, 1996).
2. Numerous commentators have urged the Service to provide general guidance on capitalization issues, rather than providing piecemeal guidance over time through the issuance of letter rulings. See, e.g., Comment of Tax Executives Institute, 96 TNT 60-19; Comment of American Bar Association Section of Taxation, 96 TNT 104-71; Comment of National Retail Federation, 96 TNT 127-21; Comment of American Bankers Association, 96 TNT 98-28; and Comment of Financial Executives Institute, 96 TNT 120-19, among others.
3. The Service placed capitalization issues on its 2001 Business Plan, which includes “proposed regulations under sections 162 and 263 regarding deduction and capitalization of expenditures.” See Notice, 2001 FED ¶ 46,425 (CCH) (Apr. 26, 2001).
4. On February 17, 2002, the Service issued an Advance Notice of Proposed Rulemaking (the “Advance Notice”) describing the regulations that it intends to propose in 2002 regarding the capitalization of costs incurred in acquiring, creating, or enhancing intangible assets. Announcement 2002-9, 2002-1 C.B. 536 (Feb. 17, 2002). Section C of the Advance Notice relates to the capitalization of transaction costs.

5. On December 19, 2002, the Service released a Notice of Proposed Rulemaking, Reg. 125638-1 (December 19, 2002), proposing regulations under section 263(a) (the "Proposed Regulations"). See Prop. Treas. Reg. § 1.263(a)-4. The Proposed Regulations generally require the capitalization of amounts paid to acquire, create, or enhance intangible assets. The Proposed Regulations also provide rules for determining the extent to which taxpayers must capitalize transaction costs that facilitate the acquisition, creation, or enhancement of intangible assets or that facilitate certain restructurings, reorganizations, and transactions involving the acquisition of capital.
6. On December 31, 2003, the Service adopted the proposed regulations under section 263(a) as revised in T.D. 9107. In the final regulations, the Services moved the rules for determining the extent to which taxpayers must capitalize transaction costs that facilitate the acquisition, creation, or enhancement of intangible assets or that facilitate certain restructurings, reorganizations, and transactions involving the acquisition of capital to Treas. Reg. § 1.263(a)-5. These regulations are discussed at length in Part Two of this outline.

II. ABANDONED TRANSACTIONS

- A. In general, expenses incurred by taxpayers in the course of a reorganization that is eventually abandoned are deductible in the year the reorganization is abandoned. Doernbecher Mfg. Co. v. Commissioner, 30 B.T.A. 973 (1934). In Doernbecher, the court held that amounts paid to investigate the possibility of a merger are deductible in the year in which the merger is abandoned.
- B. However, the rule allowing a deduction for costs incurred in an abandoned transaction does not affect the initial capital nature of an expense. Ellis Banking Corp. v. Commissioner, 688 F.2d 1376 (11th Cir. 1982). The allowed deductions following an abandoned transaction are deductible as a loss under section 165, as opposed to deductible as an ordinary and necessary business expense under section 162(a).
 1. Thus, expenses incurred in investigating a possible capital investment must be capitalized, notwithstanding the fact that the taxpayer has not made a final investment decision. Ellis Banking Corp., *supra*, at 1382.
 2. Expenditures "made with the contemplation that they will result in the creation of a capital asset cannot be deducted as ordinary and necessary business expenses even though that expectation is subsequently frustrated or defeated . . ." Union Mutual Life Insurance Co. v. United States, 570 F.2d 382, 392 (1st Cir. 1978).
 3. If the taxpayer subsequently abandons the project, the preliminary capitalized expenditures then may be deducted as a loss under section 165.

- C. In Rev. Rul. 67-125, supra, the Service ruled that capitalized legal fees attributable to a proposed distribution in redemption of stock are deductible in the year the redemption is abandoned. The Service did not, however, address whether such deduction falls under section 165 or section 162(a).
- D. Subsequently the Service ruled in Rev. Rul. 73-580, 1973-2 C.B. 86 that although compensation paid to employees in connection with a reorganization must be capitalized, amounts paid with respect to abandoned mergers or acquisitions are deductible in the year of abandonment. The Service specifically noted that such deduction falls under section 165.
- E. At least one Tax Court case implies that expenditures attributable to abandoned transactions may be deducted as an ordinary and necessary business expense under section 162. In Sibley, Lindsay & Curr, Co. v. Commissioner, 15 T.C. 106 (1950), the Tax Court held that expenses attributable to abandoned reorganizations are "a deductible expense." However, although the court implied that such expenses are ordinary and necessary business expenses, it did not explicitly say so. Thus, due to the other authorities in this area, expenses incurred by taxpayers in the course of a reorganization that is eventually abandoned should be deducted as a loss under section 165.
- F. Multiple Separate and Distinct Transactions and Multiple Alternatives
1. There is an important distinction between multiple separate and distinct transactions, and multiple alternatives to the same transaction. If there are multiple separate and distinct transactions, costs allocated to abandoned transactions are deductible in the year of abandonment under section 165. See Sibley, Lindsay & Curr, Co., supra.
 2. In TAM 9402004 (Sep. 10, 1993), a taxpayer wanted to deduct 6/7 of their costs incurred to find a buyer for their corporation, because they received seven offers and accepted only one.
 - a. The taxpayer argued that six of the seven transactions were abandoned. However, the Service held that the corporation could accept only one purchaser, and thus there were several alternatives to one possible transaction: the sale of the corporation. TAM 9402004 (Sep. 10, 1993). Because the corporation carried out one of the alternatives, all costs associated with finding a buyer must be capitalized.
 - b. Effectively, this TAM stands for the proposition that if multiple transactions are not mutually exclusive (i.e., the corporation can carry out more than one offered transaction), then the transactions are treated as multiple, separate, and distinct transactions. As such, costs related to each transaction may be deducted when abandoned.

- c. However, if the transactions are mutually exclusive (i.e., the corporation can accept only one transaction), the transactions will be treated as mere alternatives to one transaction. Thus, costs related to the transactions will not be considered abandoned unless none of the alternatives are accepted. See In re Hillsborough Holdings Corp., supra (holding that expenses of analyzing a leveraged recapitalization, which was considered as an alternative to an LBO which was ultimately consummated, were nondeductible because they were not incurred as part of a separate transaction that was later abandoned).
3. Notwithstanding the above authorities, the court in In re Federated, 171 Bankr. 603, 94-2 U.S.T.C. ¶ 50,430 (S.D. Ohio 1994), held that if there are two mutually exclusive transactions, only one of which the taxpayer could undertake, the taxpayer may deduct the fees associated with whichever transaction the taxpayer abandons, under section 165.
 - a. Interestingly, the Court in In re Federated, cited and relied on Sibley for its conclusions. In doing so, the Court misinterpreted Sibley, stating that in Sibley, the Tax Court held that "three proposals were 'separate and distinct suggestions,' only one of which the taxpayer could undertake," and holding that the reasoning in Sibley should be applied to the In re Federated facts.
 - b. Clearly, Sibley held just the opposite. The Sibley court specifically noted that the proposals in that case were not alternatives, but separate and distinct suggestions "all or any of which petitioner might have accepted."
 - c. It is unclear the effect this misinterpretation will have on the deductibility of future abandoned transactions under section 165.
4. In TAM 200512021 (December 29, 2004), the Taxpayer executed a merger with one company and later decided that it would rather merge with a different company. In order to exit the first merger agreement, the Taxpayer paid a termination fee (paying the termination fee and exiting the first agreement were conditions of the later agreement to merge with the second company). The Service stated in the TAM that the termination fee was a capital expenditure because the termination fee was paid to achieve the benefits of the superior later merger agreement.
5. In TAM 200521032 (February 11, 2005), the facts were similar to TAM 200512021. The Taxpayer entered into a merger agreement with a corporation that was newly formed to execute a leverage buy-out. The value of the Taxpayer's stock was depressed and the Taxpayer had little in the way of takeover defenses. Subsequent to the execution of the merger agreement, a second corporation made an unsolicited offer to acquire all

the outstanding shares of the Taxpayer. The Taxpayer accepted the subsequent offer and paid a termination fee to exit the prior agreement. The TAM stated that the termination fee was a capital expenditure because it was directly related to the second merger agreement.

6. In TAM 200610029 (January 1, 2006), the taxpayer created a separate corporation (X) to conduct R&D. As part of financing X, the taxpayer obtained the option to purchase all of the stock of X. Instead of exercising the option, the taxpayer made a tender offer for X's stock and then merged with X. The taxpayer claimed a loss deduction for the unexercised option. The taxpayer argued that it abandoned the option and acquired X through a separate unrelated transaction. The IRS disagreed and found that the option and the tender offer were part of a concerted effort to reacquire property. The IRS reasoned that multiple transactions need not be part of an integrated plan from the outset. If seemingly separate transactions, whether contemporaneous or in series, have a single objective, the loss deduction must be disallowed if the objective is achieved.
7. In TAM 200749013 (December, 7 2007), the taxpayer explored different transactions to restructure its businesses. The option the taxpayer chose was to spin-off a subsidiary. The taxpayer sought to deduct the costs for options it abandoned. The abandoned options were (1) a recapitalization transaction and (2) a split-off. The IRS found that the taxpayer could deduct the costs for the recapitalization option because a recapitalization and a split-off are not mutually exclusive. The IRS also found that in some cases a split-off and spin-off are not mutually exclusive, but not in this case. Thus, the taxpayer could not deduct the costs for the split-off because the split-off and the spin-off were part of a single divestiture transaction.
8. The Tax Court in Santa Fe Pacific Gold Co. v. Commissioner, 132 T.C. No. 12 (2009) held, as the court in In Re Federated held, that a taxpayer may claim a deduction in connection with an abandoned transaction even though the taxpayer entered into a mutually exclusive transaction. In Santa Fe Pacific Gold Co., the taxpayer entered into a merger agreement, but terminated the agreement upon accepting a competing bid. The IRS argued that the two potential merger transactions were mutually exclusive, and that the termination of the first transaction should be viewed as effecting the subsequent transaction. The Tax Court rejected the IRS argument, concluding that the two potential merger transactions, even though mutually exclusive, were viewed as separate and distinct and were not part of an overall plan.

- G. Summary: Expenses incurred in connection with a reorganization that is eventually abandoned are generally deductible as a loss under section 165 in the year the reorganization is abandoned, unless those expenses are related to another reorganization.

III. COSTS FOR CONTESTED ACQUISITIONS: HOSTILE TAKEOVERS

A. Resisting Unwanted Acquirers

1. In general, paying legal fees in connection with a lawsuit that could affect the financial safety of a business is "the common and accepted means of defense against attack," and such fees are thus deductible under section 162. Welch v. Helvering, 290 U.S. 111 (1933). Under analogous reasoning, professional fees incurred by a taxpayer to defend against a hostile takeover should also be deductible.
2. However, the Service has struggled with this issue. They have issued numerous authorities on this topic since 1985, each seemingly reversing the preceding one. See, e.g., TAM 8945003 (Aug. 1, 1989); TAM 9043003 (Jul. 9, 1990); TAM 9144042 (Jul. 1, 1991). See also Leveraged Buyout (LBO) ISP Coordinated Issued Paper: Costs Incurred in a Hostile Takeover Defense, 91 TNT 90-34 (April 24, 1991) ("ISP Paper") ("No absolute rules apply universally: each takeover defense is factually unique . . . [and] will have to be separately analyzed . . ."). As a result, the authorities on this issue appear to be in conflict.
 - a. In TAM 9043003, the Service stated that expenses incurred by a corporation to resist an unfriendly takeover attempt are deductible as ordinary and necessary business expenses under section 162.
 - (i) The Service noted that since the target corporation resisted the takeover and decided, in its best judgment, that the merger was detrimental to the company, there would be no future benefit to the target corporation.
 - (ii) The Service distinguished National Starch in TAM 9043003 (July 9, 1990), stating that there was no resistance to the merger in such case, thus showing that the merger yielded a future benefit. According to the Service, if the corporation in TAM 9043003 had accepted the merger offer, then the expenses should have been capitalized.
 - (iii) In defending the expenses as "ordinary and necessary," the Service stated that the target knew "from experience that payments for such a purpose . . . are the common and accepted means of defense against attack." TAM 9043003 (July 9, 1990).
 - b. In contrast, in TAM 9144042 (July 1, 1991), the Service held that investment banking, legal, tax, and media professional fees incurred to defend against a hostile takeover must be capitalized if they result in a long-term benefit to the target corporation.

- (i) The Service stated that the nature of a takeover, whether it be friendly or hostile, is not determinative of the proper tax treatment. The "proper inquiry to be made . . . is whether the target corporation obtained a long-term benefit as a result of making the expenditures."
 - (ii) As a result, TAM 9144042 concluded that professional fees incurred in resisting a takeover attempt "will not uniformly be classified as either currently deductible under section 162 of the Code or capitalizable under section 263 of the Code." Each situation will be analyzed on its own specific facts and circumstances.
 - (iii) Under the facts of the TAM, amounts paid by a target to repurchase its stock from a corporate raider must be capitalized.⁵ Amounts paid to reimburse the raider for expenses incurred in connection with a failed takeover attempt must also be capitalized.
 - (iv) Note: Although INDOPCO had not been decided when the Service issued TAM 9144042, the Service did cite National Starch in making its determination as to whether fees incurred to resist a hostile takeover must be capitalized or could be deducted currently.
- c. In Victory Markets, Inc. v. Commissioner, 99 T.C. 648 (1992), the Tax Court also required capitalization of takeover defense expenses. In Victory Markets, a target corporation incurred costs in evaluating whether to accept a merger offer from an acquiring corporation. The target rejected the offer initially, but eventually accepted the offer after the acquirer increased the amount it would pay for target shares.
- (i) Although the target argued that the takeover was "hostile," the Tax Court held that the acceptance of the offer showed that the merger was "friendly," and thus the costs must be capitalized under INDOPCO. The court noted that the acquirer never attempted to circumvent the board of directors by making a tender offer to the shareholders directly.

⁵ The TAM does not address the effect of section 162(k), infra, because the facts in the TAM occurred in 1984, and section 162(k) was not effective until 1986. See Tax Reform Act of 1986, section 613.

- (ii) Furthermore, a long term benefit inured to the target, as they would not have accepted the offer of merger if it was not advantageous to the company.
- d. However, in In re Federated, 171 Bankr. 603, 94-2 U.S.T.C. ¶ 50,430 (S.D. Ohio 1994), the Court held that takeover defense expenses were deductible. In In re Federated, a target resisted a corporate raider, incurred expenses to find a white knight, was subsequently bought out by the corporate raider, and thus did not merge with the white knight (and paid such white knight break-up fees).
 - (i) In the end, the Board of the target actually approved the merger with the corporate raider.
 - (ii) The court held that the fees associated with resisting the merger with the corporate raider were deductible business expenses. Even though the merger ultimately occurred, the court argued that no synergy between the two companies was created like that in INDOPCO, and thus there was no long term benefit. The merger was effectively forced on the target, and the court believed that there was no long term benefit as the corporate raider "was inexperienced in the . . . field." In re Federated, at 609.
 - (a) This argument seems to run counter to that made by the Victory Markets court. Under the reasoning in Victory Markets, the board's approval of the merger is indicative of a long term benefit, as the board has a fiduciary duty to do what is best for the company. The In re Federated Court, however, held that although the board approved a merger, there was no future benefit.
- e. In Santa Fe Pacific Gold Co. v. Commissioner, 132 T.C. No. 12 (2009), the Tax Court held that a target company may deduct a termination fee paid in connection with a failed merger between the target company and a white knight. In Santa Fe Pacific Gold Co., a target company entered into a merger agreement with a white knight at a time when the target company was the subject of a hostile takeover attempt by a competing mining company. The competitor subsequently increased its bid for the target company, and the Board of the target company ultimately approved a merger with the competitor. As a result, the target company paid the termination fee to the white knight.

- (i) After the merger, the acquiring company reduced duplicative costs by closing the offices of the target company and eliminating most positions held by target company employees and managers. Furthermore, the Board of the target company resigned and long term plans of the target company were abandoned.
 - (ii) The Tax Court held that the target company could deduct the termination fee paid to the white knight. The Tax Court focused on target company's operations in concluding that the payment of the termination fee did not give rise to a long-term benefit that would require capitalization. The Tax Court noted that the target company "effectively ceased to exist" after the merger. The Tax Court did not conclude, as argued by the IRS, that the target company incurred the termination fee in order to enter into the merger agreement with the competitor, which maximized value for the shareholders of the target company on a going forward basis.
- f. In A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166 (1995), rev'd 119 F.3d 482 (7th Cir. 1997), the Tax Court and the Seventh Circuit disagreed as to whether takeover defense expenses are deductible. The Seventh Circuit ultimately found them to be deductible.
 - (i) The target in A.E. Staley rejected two offers from the acquirer before eventually approving a plan of merger.
 - (ii) The Tax Court held that investment banking fees and printing costs incurred in response to hostile offers were capital expenditures, since the offers were eventually approved. Unlike Victory Markets, the Court in A.E. Staley concluded that it did not matter whether the takeover attempt had been hostile or friendly because the board eventually accepted the offer of merger. Thus, there was a long-term benefit in connection with a change in corporate structure, which must be capitalized.
 - (iii) The Court distinguished In re Federated, noting that there was no failed white knight transaction in A.E. Staley, and stating that the In re Federated court relied not on the fact that the takeover attempt was hostile but on the fact that the target "did not obtain any significant future benefits" due to the merger. A.E. Staley, supra, at 199.

- (iv) The Tax Court's decision in A.E. Staley was reversed by the Seventh Circuit on appeal. The Court of Appeals noted that the distinction between hostile and friendly takeovers was relevant. The investment banking fees incurred by the target corporation in A.E. Staley actually "frustrated the occurrence of the merger that eventually took place," and were incurred in order to defeat "a hostile tender offer by exploring alternate capital transactions." The Court concluded that, since the target incurred the costs "in the process of defending its business from attack," such costs were deductible under section 162.
 - (v) Furthermore, the Court stated that "INDOPCO did not change the law with respect to costs incurred to defend a business. Such costs seek to preserve the status quo, not to produce future benefits, and are therefore deductible."⁶
 - (vi) Recently, in Illinois Tool Works Inc. and Subsidiaries v. Commissioner of Internal Revenue, 355 F.3d 997 (7th Cir. 2004), the Seventh Circuit described its decision in A.E. Staley as applying "a 'pragmatic assessment' to the underlying facts in order to decipher whether . . . fees incident to [a] hostile takeover [are] for current defense of the company or for an ultimate corporate change with benefits lasting into the future." Id. at 1004.
- g. A Service official stated that the Service's "view of the world is not changed by [the Seventh Circuit's decision in] Staley. [The Service] will continue to look at the facts, and if they indicate a substantial, long-term beneficial consequence, [the Service] would argue capitalization." See IRS Has No Answers To Sticky Audit Issues Emerging Under INDOPCO, 98 TNT 23-6.
 - h. In FSA 200103004 (Sept. 11, 2000), the Service took the position that costs incurred in the defense of a hostile takeover must be capitalized. The Service, citing INDOPCO and expressly dismissing the taxpayer's reliance on A.E. Staley and In re Federated, stated that A.E. Staley and In re Federated "ignore the tenet that expenses incurred in connection with the creation and

⁶ The 7th Circuit in A.E. Staley cited to an earlier version of this article in support of the conclusion that INDOPCO did not create an inflexible test under which expenses would be capitalized if there is a future benefit. See A.E. Staley at note 5 (stating that the earlier version of this article noted that "the IRS has ruled that INDOPCO did not alter deductibility of advertising costs, incidental repair costs or severance payments, even though they may have a future effect on business activities").

adoption of a shareholder rights plan or other corporate capital structure should be capitalized.”

- (i) In FSA 200103004, the target taxpayer incurred investment advisor, banking, and attorney fees in an unsuccessful attempt to defend against a hostile takeover. Specifically, the target expended funds in the issuance of preferred stock purchase rights to its common stock holders, filing a lawsuit against the hostile acquirers, defending several lawsuits by the hostile acquirers, postponing an annual meeting of the shareholders during a proxy fight initiated by the hostile acquirers, and actively evaluating alternatives to the hostile acquirers’ tender offer.
 - (ii) Once it became apparent that all defensive attempts and plausible alternatives were futile, the target’s board of director’s announced that the target was “for sale to the highest bidder.” The target’s board later recommended that the shareholders accept an offer from a corporation owned by the hostile acquirers. Accordingly, the corporation obtained 80 percent of the target’s voting stock and then merged into the target. The target deducted the costs incurred in defending against the hostile takeover as ordinary and necessary business expenses.
 - (iii) In denying the claimed deductions, the Service found that the facts were almost identical to those of INDOPCO with the only major distinction being that INDOPCO involved a friendly takeover. Moreover, the Service determined that “it is of no consequence that the measures were adopted for the immediate purpose of defending against hostile merger overtures.” As a result, the target was forced to capitalize the expenses incurred in defending against the hostile takeover.
- i. Note. The Service has made clear that in order to deduct any fees incurred in resisting hostile takeovers, the taxpayer has the burden to show which expenses directly relate to resisting the takeover. If the taxpayer cannot prove that specific funds relate to deductible fees, all amounts must be capitalized. See, TAM 9043003; ISP Paper, supra, 53. But see FSA 200103004 supra (denying all deductions claimed in the defense of a hostile takeover).

3. Fees Paid to White Knights

- a. The Service has ruled that fees incurred to facilitate a friendly merger with a white knight in order to defeat a hostile takeover

must be capitalized. TAM 9043003; FSA 199308201, 98 ARD 156-8 (Sept. 20, 1993) (holding that, in light of the white knight's involvement, the change in the corporate structure went beyond merely defending a business from threatened destruction; consequently, expenditures properly allocable thereto should be capitalized).

- b. However, at least one court has held that expenses incurred to break-up a merger through the use of a white knight may be deducted.
 - (i) The court in In re Federated held that "costs incurred to defend a business against attack are ordinary and necessary expenses." Id., at 610. The Court also held that break-up fees paid to the white knight are deductible as a business expense under section 162. Id. Furthermore, the court concluded that break-up fees are also deductible as a loss under section 165, because loss deductions are allowed for abandoned capital transactions. But see Part III.F.3., supra.
 - (ii) The court specifically noted that its decision is consistent with INDOPCO.

4. Costs Incurred in Pac-Man Defenses

- a. Under the "Pac-Man" defense, a target acquires an acquirer pursuant to a counter-tender offer.
- b. The Service has advised that costs associated with such counter-tender offers would be "considered part of the cost of acquiring the stock" and would thus be capital in nature. ISP Paper, supra.
- c. If however, the counter-tender offer were abandoned, the costs would be deductible under section 165 in the year of abandonment.

5. Poison Pills

- a. A "Poison Pill" is a right issued by corporations to its existing shareholders to buy stock at a below market price if a corporate raider purchases a certain percentage of the corporation's stock.
- b. The Service has advised that expenses incurred in issuing a poison pill are nondeductible capital expenditures, because expenses incurred by a corporation in making distributions to its shareholders (in this case, contingent stock rights) are generally capital in nature, especially when the rights pertain to the capital structure of the corporation. ISP Paper, supra.

6. Summary

There is mixed authority on whether expenses incurred to defend against a hostile takeover are deductible. While it seems clear that the Service believes such expenses should be capitalized, see FSA 200103004, supra, a number of courts have held that expenses incurred to defend against a hostile takeover may be deducted because they do not normally result in a long-term benefit to the target corporation. However, some cases have held to the contrary. See Victory Markets, supra. At least one court has held that break-up fees paid to a white knight are deductible as a business expense under section 162. See In re Federated, supra. Furthermore, the Service has stated that costs incurred in Pac-Man defenses or in poison pill plans must be capitalized.

B. Redemptions of Stock

1. Introduction

a. In order to prevent hostile takeovers, corporations often will incur expenses to redeem shares of their stock. The target typically offers to purchase the acquirer's target stock for amounts above the fair market value of the stock (usually referred to as "greenmail") in order to end the threat of a hostile takeover.

(i) In Five Star Mfg. Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), a corporation redeemed stock from a shareholder that refused to pay a debt it owed to the corporation. The corporation made such redemption in order to collect the funds owed and facilitate a future business arrangement vital to the corporation with a party that refused to enter into such business arrangement if the indebted shareholder remained with the corporation. The court held that expenses related to the redemption were deductible under section 162.

(ii) As a result of Five Star, some corporate taxpayers took the position that greenmail payments were deductible. See Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, H.R. Rep. 99-3838, at 277 (1987). Although not entirely clear, even before the enactment of section 162(k), greenmail payments were presumably nondeductible. See Stokely-Van Camp, Inc. v. United States, 21 Cl. Ct. 731 (1990) (stating that enactment of section 162(k) provides no inference that greenmail payments were deductible prior to such section, and holding that greenmail payments must be capitalized); Wrangler Apparel Corp. v. United States, 931 F. Supp. 420

(M.D.N.C. 1996) (same); H.R. Rep. 99-3838, supra (clarifying that greenmail payments are nonamortizable capital expenditures).

- (iii) In order to prevent this result, Congress enacted section 162(k).

2. Section 162(k)

- a. Section 162(k) of the Code, as enacted in 1986, disallows a deduction for any amount “paid or incurred by a corporation in connection with the redemption of its stock.”⁷
- (i) Amounts included under section 162(k) include amounts paid to repurchase stock, fees incurred in connection with such repurchase (i.e., legal, accounting, appraisal, and brokerage fees), and any other expenditures necessary or incidental to the repurchase. See H.R. Rep. No. 99-426, at 249 (1985), 1986-3 C.B. vol. 2 249; S. Rep. No. 99-313, at 223 (1985), 1986-3 C.B. val. 3 223; Custom Chrome, Inc. v. Commissioner, 217 F.3d 1117 (9th Cir. 2000) (stating that section 162(k) does not allow a deduction for legal and professional fees associated with a corporation’s repurchase of its sole shareholder’s stock pursuant to a leveraged buyout).
 - (ii) However, interest expense incurred as part of a redemption is excepted from the disallowance under section 162(k).
 - (iii) Section 162(k) also does not preclude deductions of employee severance payments or payments pursuant to employee stock option plans or phantom stock plans, to the extent such payments represent compensation for the performance of services and not additional redemption proceeds. FSA 199305101, 98 ARD 157-9 (May 10, 1993).
- b. In 1996, Congress amended section 162(k) to include not just redemption expenses, but expenses incurred in any acquisition of previously outstanding stock of the corporation or any related person.
- (i) Section 162(k) now states that no deduction is allowed for amounts paid or incurred by a corporation in connection with “the reacquisition of its stock or of the stock of any related person”
 - (ii) Thus, the section 162(k) rules now apply to transactions treated as a reorganization, a dividend, a sale of stock, or any other transaction involving a corporation's acquisition of its own stock. See H.R. Rep. No. 104-486, at 183-84

⁷ This language applied prior to a change in the Small Business Job Protection Act of 1996.

(1996), 1996-3 C.B. 521-22 (hereinafter "House Report"). The amendment applies to amounts paid or incurred after September 13, 1995.

- (iii) The scope of this amendment to section 162(k) is not entirely clear. However, it seems that the new language attempts to add those transactions that are a reacquisition of company stock, but not technically a redemption under section 317(b). For example, section 162(k) now seems to cover costs incurred in the recapitalization of a corporation's stock, where the corporation issues new company stock to shareholders in exchange for old company stock.
 - (a) Because stock in the corporation is not "property" under section 317(a), such a recapitalization is not technically a redemption under section 317(b).
 - (b) Old section 162(k) presumably would not have covered such a transaction.
 - i) Under section 355, this transaction is tax-free, and is not technically a redemption.
 - ii) However, the transaction is a reacquisition of corporate stock that new section 162(k) should cover, and that old section 162(k) presumably would not.
 - (c) Note: The Service has held that section 317(b) has general application, applying to reorganizations and other transactions, in addition to Part I of subchapter C (sections 301 to 318) of the Code. TAM 9627003 (Feb. 28, 1996).
- (iv) Another transaction that new section 162(k) could cover is a section 355 divisive "split-off" transaction. Under such a reorganization, a corporation distributes stock in a subsidiary to a shareholder in exchange for the shareholder's stock in the corporation.
- (v) In FSA 200206005 (Oct. 26, 2001), the Service determined that new section 162(k) applies to redemption payments made by a corporation under a chapter 11 bankruptcy plan in satisfaction of a judgment. Several shareholders were required by the state trial court to surrender their stock in the corporation before they could proceed under a breach of fiduciary duty claim and seek relief in the amount of the

decline in stock value resulting from the breach. The trial court ruled in favor of the suing-shareholders and shortly thereafter, the corporation filed a chapter 11 bankruptcy petition. Under the bankruptcy plan of reorganization, the corporation satisfied the judgment by making cash payments to the Plaintiffs. The corporation deducted these payments under section 162. The Service determined that the payments were nondeductible business expenses because they were made in consideration for the shareholders' stock.

- (vi) In Media Space Inc. v. Comm'r, 135 TC 20 (2010) the Tax Court did not apply the 162(k) deduction limitation to payments made to investors under an agreement to forbear the exercise of stock redemption rights. The IRS had argued that the taxpayer had in substance exchanged the forbearance payments and new preferred stock with deferred redemption payments for old preferred stock with nondeferred redemption rights. However the court did find that some of the payments had to be capitalized under section 263 and the INDOPCO regulations, Treas. Reg. § 1.263(a)-4(d)(2)(i).
- (vii) Note: The proposed section 197 regulations stated that section 162(k) disallows any deduction for amounts paid or incurred pursuant to covenants not to compete acquired in connection with the reacquisition of a corporation's stock. However, the final section 197 regulations make no reference to section 162(k). Treas. Reg. §1.197-2; T.D. 8865, 2000-1 C.B. 589 (Feb. 14, 2000).

3. Costs of Obtaining Financing to Redeem Shares

- a. In general, expenses incidental to securing a loan are nondeductible, but amortizable over the life of the loan. See Rev. Rul. 70-360, 1970-2 C.B. 103. See also, McCrory Crop. v. United States, 651 F.2d 828 (2d Cir. 1981) (noting that expenses in connection with raising capital are nondeductible).
- b. Pre-1996 Authorities
 - (i) In In re Kroy, 27 F.3d 367 (9th Cir. 1994), the Ninth Circuit held that loan fees incurred in obtaining a loan for a leveraged buyout ("LBO") could be amortized and deducted over the term of the loan.

- (a) The corporation in In re Kroy decided to go private through an LBO. Since the corporation did not have the funds to purchase its stock, it borrowed \$60.6 million from a bank to finance the LBO. In obtaining the loan, the corporation incurred advisory fees, placement fees, credit arrangement and facility fees, closing fees, bank agent fees, and legal and accounting fees.
 - (b) The Service in In re Kroy argued that the phrase "in connection with the redemption of stock" in section 162(k) (prior to its change in 1996) includes loan fees incurred in order to borrow funds to finance a stock redemption.
 - (c) However, the court reasoned that, although the term "in connection with the redemption of stock" is critical, the fees were incurred as compensation for services rendered in a "separate and independent" borrowing transaction, and not in a redemption transaction. Thus, the court followed the "origin of the claim" test established by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963).
 - (d) Under the origin of the claim test, the fees in In re Kroy had their "origin" in the borrowing transaction, and were incurred as compensation for services rendered to the corporation by its investment banker and lenders.
 - (e) The In re Kroy court thus noted that there were two transactions: a stock redemption transaction and a borrowing transaction. Section 162(k) does not apply to fees incurred in borrowing funds where the loan proceeds are used to redeem stock.
- (ii) In Fort Howard Corp. v. Commissioner, 103 T.C. 345 (1994). The Tax Court disagreed with In re Kroy, and held that costs incurred in debt financing an LBO (other than interest costs) are nondeductible under section 162(k) (prior to its change in 1996), as well as nonamortizable.
 - (a) The court noted that there would be no reason to have an interest exception in section 162(k) if financing costs were not related to redemptions.

- (b) Furthermore, the Fort Howard court stated that the term "in connection with" clearly implied that financing costs fall under the ambit of section 162(k). The court also argued that the "origin of the claim" test is inapplicable in this situation.
 - (iii) The Service has stated that it agreed with the result in Fort Howard. ISP Paper, supra.
 - (iv) As discussed below, the amendment to section 162(k), included in the Small Business Protection Act of 1996, effectively overruled Fort Howard.
 - (v) It is unclear to what extent the analysis in In re Kroy and Fort Howard could apply to other fees incurred in connection with redemptions, such as covenants not to compete.
- c. The 1996 Amendment
 - (i) Section 162(k)(2)(A)(ii), enacted by the Small Business Job Protection Act of 1996, provides that the disallowance rules of section 162(k)(1) shall not apply to any "deduction for amounts which are properly allocable to indebtedness and amortized over the term of such indebtedness." Section 162(k)(2)(A)(ii).
 - (a) In response to this enactment, the court in Fort Howard issued a new opinion permitting the taxpayer to deduct and amortize its financing costs and fees over the term of the loan. Fort Howard Corp. v. Commissioner, 107 T.C. 187 (1996).
 - (ii) Thus, corporations are permitted to amortize costs attributable to obtaining debt financing for reacquiring its own (or a related party's) stock, and deduct them over the term of the loan. See, e.g., In re Hillsborough Holdings, Corp., supra (holding that professional fees related to obtaining the financing for an LBO are debt-issuance expenses that should be amortized over the term of the debt).
 - (iii) This new exception applies to amounts paid or incurred after September 13, 1995. House Report, supra. Note that the two new amendments to section 162(k) have different effective dates.
- d. Self-Tender Offers

- (i) A self-tender offer is undertaken by a target to buy its own stock in the face of a hostile takeover.
- (ii) The Service treated a self-tender offer as a stock redemption prior to 1996. ISP Paper, supra. Thus, costs associated with self-tender offers were not deductible under section 162(k), prior to the 1996 change.
- (iii) However, the 1996 amendment to section 162(k) should allow corporations to amortize costs incurred in financing a self-tender offer.

e. Qualified Stock Purchases under Old Section 338

- (i) In TAM 9609004 (Nov. 6, 1995), a question arose as to whether section 162(k) would apply to costs incurred in a section 338 transaction structured as a stock purchase and redemption.
 - (a) In the technical advice memorandum, P owned TA, and X owned T. TA purchased the T stock for cash. TA then merged into T, with T surviving. P filed a section 338(g) election.
 - (b) In order to pay for the T stock, P contributed cash to TA and TA borrowed funds from a bank. As a result of the subsequent merger of TA into T, T assumed TA's debt.
 - (c) The taxpayer in TAM 9609004 agreed that had they not made a section 338 election, the transaction would have been in part a redemption, and section 162(k) would have denied a deduction of any of the expenditures incurred in connection with the redemption. However, the taxpayer argued that the section 338(g) election disregards the redemption and the stock purchase and turns the transaction into an asset purchase.
 - i) A transaction is classified as a redemption if a purchaser borrows funds, merges into a target with the target surviving, and such target assumes the liability for the borrowed funds. See TAM 9645003 (Jul. 12, 1996).
 - ii) Note, however, that if the benefits and burdens of a loan are borne by the parent of a corporation that merges into a target, and

the target does not have any responsibility to pay off the loan, the transaction will be treated as a purchase and not a redemption. Id.

(d) The Service held that section 162(k) applied because section 338 does not change the character of the entire transaction. It merely treats the stock purchase as an asset purchase. The redemption was a transaction separate from a Qualified Stock Purchase.

(ii) Note that it is not clear whether this ruling would also apply to a section 338(h)(10) election.

4. Summary

Amounts paid by a corporation in connection with the reacquisition of its stock must generally be capitalized. Section 162(k). Thus, greenmail payments must be capitalized. Prior to the enactment of the Small Business Job Protection Act of 1996, there was a question as to whether costs of obtaining financing in order to redeem stock were subject to section 162(k) disallowance. See In re Kroy and Fort Howard, *supra*. However, the amendment to section 162(k), added in 1996 by the Small Business Job Protection Act, specifically allows a corporation to amortize costs of obtaining financing in order to reacquire its stock.

IV. COSTS INCURRED IN DIVISIVE REORGANIZATIONS

A. General Rule

1. Costs incurred in connection with divisive reorganizations under section 355 generally must be capitalized. See P.L.R. 8816026 (Jan. 15, 1988) (holding that, because a spin-off pursuant to section 355 constitutes a reorganization which changes the structure of the surviving corporation, any expenditure incident to such a reorganization is a capital expenditure).
2. No case has specifically applied INDOPCO to section 355 reorganizations, although a few cases appeared to rely on the INDOPCO "future benefit" theory. See E.I. DuPont de Nemours v. United States, 432 F.2d 1052 (3rd Cir. 1970) (disallowing expenses incurred in non pro-rata split-off as expenses resulted in benefit expected to produce returns for many years in future); The Farmers Union Corp. v. Commissioner, 300 F.2d 197 (9th Cir. 1962) (denying deduction for legal, escrow, and accounting expenses incurred in partial liquidation because taxpayer could not prove that such expenses did not change corporate structure for benefit of future operations).

B. Divestiture Required by Law

1. Several cases in the divisive reorganization area involve partial liquidations and reorganizations which are required by a statute or court.
2. For example, in United States v. General Bancshares Corp., 388 F.2d 184 (8th Cir. 1968), a bank holding company proceeded to divest itself of non-banking assets in order to comply with the newly enacted Bank Holding Act of 1956.
 - a. The company decided to organize Newco and transfer all non-banking assets to Newco in exchange for Newco stock. The company then distributed such Newco stock pro-rata to its shareholders.
 - b. The company incurred accounting fees, transfer agent fees, transfer taxes, and the costs of documentary stamps.
 - c. The court held that such expenses were deductible business expenses, because the "dominant aspect" of the company's divestiture plan was the liquidation of its non-banking assets, and not a reorganization of the company. General Bancshares, supra, at 191.
 - (i) The dominant aspect test was adopted in Gravois Planning Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962), and provides that where "a partial liquidation is accompanied by the corporation's recapitalization or reorganization, the transaction is to be viewed as a whole and its dominant aspect is to govern the tax character of the expenditures."
 - (ii) The court in Gravois went on to provide that where a corporation "has what is essentially 'a change in the corporate structure for the benefit of future operations' there is no deduction" available. Gravois Planning Mill, at 208. See Mills Estate v. Commissioner, 206 F.2d 244 (2d Cir. 1953).
 - (iii) In General Bancshares, the court concluded that the dominant aspect of the corporation's plan of divestment was the liquidation of non-banking assets, and any reorganization "was incidental to such liquidation." General Bancshares Corp., supra, at 191. Any distribution or liquidation of assets effects some change in corporate structure. However, such a change must be "of some benefit, tangible or intangible, to the taxpayer in its future operations before it can be deemed more than incidental to

the distribution or liquidation." General Bancshares Corp., supra, at 191.

- (iv) Note: The court in General Bancshares did hold that costs of making new engraving plates and the printing of new stock certificates in connection with the change of the corporation's name following the reorganization were nondeductible capital expenditures. The court reasoned that the corporation did not have to change its name, and such expenditures were incurred in connection with acquiring a capital asset: a business name.
3. In United States v. Transamerica Corp., 392 F.2d 522 (9th Cir. 1968), the Ninth Circuit held that expenses incurred in connection with a partial liquidation and spin-off were deductible, for the same reasons as in General Bancshares. As in General Bancshares, the corporation in Transamerica was carrying out a plan of divestment in compliance with the Bank Holding Company Act of 1956. The court held that the change in corporate structure was incidental to the liquidation.
 4. In The El Paso Co. v. United States, 694 F.2d 703 (Fed. Cir. 1982), a gas pipeline company incurred legal, accounting, and consulting fees in order to comply with an anti-trust decree requiring the company to divest itself of certain assets.
 - a. The corporation in El Paso divested itself of such assets by transferring them to Newco for Newco stock, and distributing such Newco stock to its shareholders.
 - b. As in General Bancshares and Transamerica, the court held that there was no benefit to the corporation in liquidating its holdings and spinning them off. The El Paso Co. v. United States, 694 F.2d 703 (Fed. Cir. 1982). Thus, the expenses were deductible.
 5. In FSA 9999999962, 99 ARD 037-1 (date not given), the Service stated that, in appropriate cases, legal expenses incurred in connection with a divestiture decree may be bifurcated. Thus, expenses incurred in obtaining advice as to how best to comply with a divestiture decree might be regarded as attributable to the defense of the antitrust litigation, and thus deductible. However, if a plan of divestiture involves restructuring of the enterprise, legal expenses incurred in carrying out the plan should be capitalized.
 6. Note: A question arises as to whether new section 162(k), described in Part IV.B.2-3, above, will affect the deductibility of expenses incurred in divesting as required by a court or statute. Presumably, section 162(k) could require a corporation to capitalize such expenses if the divestment

mechanism used is a split-off, where the corporation distributes a subsidiary's stock to a shareholder of the corporation in exchange for the shareholder's stock in the corporation.

C. Future Benefits and the Application of INDOPCO.

1. The application of INDOPCO to divisive reorganizations is less clear than its application to acquisitive reorganizations. The argument that there is a "future benefit" to a corporation that incurs costs in a section 355 transaction is less convincing than in an acquisitive transaction, because a divisive reorganization does not create a new asset. Although INDOPCO provides no requirement that a distinct new asset be formed in order for costs to be capitalizable, it is more difficult to pinpoint a specific future benefit when a company divests itself of a portion of its business.
2. However, if a corporation decides to divest itself of a part of its business (barring a statutory or court induced divestment requirement), there presumably is some benefit to the corporation.
 - a. In order to qualify under section 355, a corporation must have a corporate business purpose.
 - b. Such business purpose presumably results in a benefit to the corporation. See Rev. Proc. 96-30, Appendix A, 1996-1 C.B. 696.
3. In any event, whether INDOPCO will apply to require the capitalization of costs incurred in divisive reorganizations is an issue that still must be addressed by the Service and the courts. However, it does not seem that the application of INDOPCO in the divisive reorganization area would yield a result much different than the previous holdings in this area, E.I. DuPont de Nemours and The Farmers Union Corp., referred to above.

D. Summary

As a practical matter, the divisive reorganization authorities use the same "future benefit" test as the INDOPCO court (although the divisive reorganization cases pre-date INDOPCO), and, thus, cases will be decided on their facts and circumstances. It remains to be seen, however, whether the courts will explicitly adopt INDOPCO in analyzing costs incurred in connection with divisive reorganizations.

V. COSTS ATTRIBUTABLE TO PROXY FIGHTS

- A. Expenses incurred by a corporation in a proxy fight, including legal fees, solicitors' fees and public relations fees are generally deductible under section 162. Locke Mfg. Co. v. United States, 237 F. Supp. 80 (D. Conn. 1964); Rev. Rul. 67-1, 1967-1 C.B. 28. See Rev. Rul. 64-236, 1964-2 C.B. 64 (allowing deductions of proxy fight costs for individual shareholders under section 212).

Cf. Dyer v. Commissioner, 352 F.2d 948 (8th Cir. 1965) (denying deduction because on facts, proxy fight would not affect dividend income or stock value).

1. Expenditures for proxy fights concerned with a question of corporate policy are ordinary and necessary, and deductible by a corporation. Rev. Rul. 67-1, supra.
 2. However, the Service has noted that it will "continue to scrutinize" costs incurred in proxy fights to determine if the costs are made "primarily for the benefit of the interests of individuals rather than in connection with questions of corporate policy." Id. If proxy costs are for the benefit of individuals, deductions will be disallowed.
- B. Amounts paid by a corporation to both the losers and the winners of a proxy fight in order to reimburse them are also deductible under section 162 as an ordinary and necessary business expense. Central Foundry Co. v. Commissioner, 49 T.C. 234 (1967).
- C. Note: Proxy costs incurred by a corporation primarily for the benefit of shareholders are nondeductible and may constitute a constructive distribution to such shareholders. See, e.g., FSA 199306161, 98 ARD 167-3 (Jun. 16, 1993).
- D. Summary: Expenses incurred by a corporation in a proxy fight are generally deductible.

VI. EXAMPLES

A. Example 1

1. Facts: P, a corporation, wishes to acquire a target corporation to increase its productivity. P incurs \$150,000 in legal and professional fees in looking for a potential company to buy. After analyzing ten companies, P makes an offer of merger to T corporation on January 1, 1996. In order to analyze whether T should accept P's offer, T spends \$100,000 in investment banking, legal and professional fees. After analyzing P's offer, T's board of directors turns P down. A week later, P makes another offer to purchase T. T turns P down again and, in order to prevent what it perceives as a potential hostile takeover, immediately contacts W, a friendly corporation, to see if W is interested in merging with T. T begins merger negotiations with W and incurs \$25,000 in costs. However, P makes a final offer that is too good to turn down, and T's board of directors approves a merger with P. As a condition to the merger, P requires T to purchase all outstanding stock options held by employees of T. As a result of the failed merger with W, T pays W \$50,000 in break-up fees.
2. \$150,000 Legal and Professional Fees

- a. The first issue is whether P may deduct the \$150,000 it incurred in researching a company to purchase. In Ellis Banking, *supra*, the Eleventh Circuit held that accounting fees paid by an acquirer to investigate the financial condition of a target, incurred in connection with the acquisition of such target, must be capitalized.
- b. The Ellis Banking case differs from the above facts only in that P was looking into purchasing companies other than T. In Ellis Banking, the corporation expended the costs in researching the corporation that it eventually merged with. However, the court in Ellis Banking noted that expenses of investigating a capital asset generally must be capitalized.
- c. Nevertheless, P could argue that the Eighth Circuit's holding in Wells Fargo, *supra*, permits a deduction for the costs incurred in researching potential companies. In Wells Fargo, the Court held that costs properly attributable to the investigatory stage of a transaction are deductible if ordinary and necessary.
- d. P could argue that it incurred the \$150,000 costs while looking for a potential company to buy. These costs were incurred prior to P's final decision to acquire T, and hence, were investigatory. Moreover, such costs incurred are undoubtedly ordinary and necessary. Furthermore, P could argue that its deduction is supported by the Service's position taken in Rev. Rul. 99-23, *supra*.
- e. In Rev. Rul. 99-23, the Service concluded that investigatory costs are defined as those costs related to the determination of whether to acquire a business and which business to acquire. Indeed, the Service cited Rev. Rul. 99-23 in acquiescing to several of the claimed deductions in Wells Fargo. Hence, P could argue that the \$150,000 was expended in order to determine whether to acquire a business and which of the ten companies to acquire. It follows that, as in Wells Fargo, P did not make a final decision to acquire T until some corporate action was taken in pursuit of the specific acquisition (i.e., a board resolution to make a tender offer).
- f. The Service could to argue that Rev. Rul. 99-23 pertains to start-up costs under section 165, not deductions under section 162, and that the holding of Rev. Rul. 99-23 is limited to the facts of the ruling. The Service could also argue that its acquiescence in Wells Fargo was nothing more than an acquiescence in a specific case, not generally, and nothing should be inferred from it. Also, the Service could argue that Wells Fargo is factually distinguishable because it applied to a target's investigatory expenses and P is an acquiring corporation. Despite these potential arguments to the

contrary, P should be able to deduct the \$150,000 based upon Wells Fargo and Rev. Rul. 99-23.

- g. P can also argue that P "abandoned" possible mergers with nine other companies, and thus may deduct 9/10 of the \$150,000, or \$135,000.
 - (i) Such an argument will, in all likelihood, be denied by the Service. In TAM 9402004, supra, the Service held that a corporation that incurred expenses in trying to find a buyer for the company had to capitalize all its costs, even though it only followed through with one of seven possible mergers.
 - (ii) The Service advised that there were several alternatives to one transaction, as opposed to multiple transactions.
 - (iii) However, P may attempt to distinguish TAM 9402004 by arguing that P, as an acquirer, may purchase more than one company. In the TAM, however, the corporation, as a target, could only be purchased by one company. Thus, P may argue that it may deduct costs under section 165 for nine abandoned transactions.
- h. It is unclear whether the Service would prevail in court. Thus, P may successfully argue that 9/10 of \$150,000 is deductible, if it can show that there are multiple separate and distinct transactions, as opposed to alternatives to one transaction. See Sibley, Lindsay & Curr, supra. Cf. In re Federated, supra (misinterpreting Sibley, and holding that if there are two mutually exclusive transactions, taxpayer may deduct fees associated with abandoned transaction under section 165).

3. \$100,000 Investment Banking, Legal and Professional Fees Incurred by T

- a. The facts of P's case are similar to those of Wells Fargo, supra, where the Eighth Circuit permitted, and the Service acquiesced to, a target's claimed deductions for costs incurred in determining whether a takeover bid was beneficial for both the company and the community.
- b. In the present case, T incurred \$100,000 of expenses in researching whether to accept a takeover bid. The only real distinction between the present case and Well Fargo is that in Wells Fargo, the proposed merger was never rejected. Nonetheless, T can argue that it should be allowed to deduct the \$100,000 either on the grounds that it ultimately accepted a bid from P (making Wells Fargo indistinguishable) or because the costs were incurred prior to

a final decision not to accept P's bid and are properly attributable to the investigation of whether to accept P's bid.

- c. If the fees were incurred as a result of a hostile takeover, T could argue that the ultimate merger created no "synergy," and thus, under the holding of In re Federated, supra, there was no future benefit to T. If this is the case, T could immediately deduct the fees. See also A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482 (7th Cir. 1997), rev'g 105 T.C. 166 (1995). But see Victory Markets, supra (holding that a target in a "hostile" takeover that eventually accepts an offer from a hostile acquirer must capitalize the costs incurred in evaluating whether to accept the offer).
- d. However, the Service is likely to argue that In re Federated and A.E. Staley Mfg. Co. were wrongly decided, and insist that "it is of no consequence that the measures were adopted for the immediate purpose of defending against hostile merger overtures." FSA 200103004 (Sept. 11, 2000). Accordingly, the Service would likely argue that, under INDOPCO, the expenses resulted in a future benefit to the target corporation and must be capitalized. See Id.
- e. In practice, it should not really matter whether an acquirer is designated as "friendly" or "hostile," as the test should be whether a final decision had been made regarding whether to accept or deny an acquisition attempt, and whether the expenses incurred prior to such decision were ordinary, necessary, and properly attributable to investigating whether to be acquired. Wells Fargo, supra; Rev. Rul. 99-23, supra. Indeed, the Service has held that it is of no consequence whether the costs were incurred in a friendly or hostile takeover. FSA 200103004.

4. Condition that T purchase Stock Options Held by Employees

- a. Under Rev. Rul. 73-146, supra, payments to employees terminating unexercised stock options in order to facilitate a reorganization are generally deductible under section 162. See also PLR 954003, supra.
- b. Such payments are compensation to the employees, and are deductible as such. They are not in satisfaction of a new obligation generated by the reorganization.
- c. Thus, payments by T to its employees to purchase the employees' stock options will be deductible as ordinary and necessary under section 162.

5. \$50,000 Break-up Fee to W; \$25,000 Cost Incurred in Negotiations

- a. The In re Federated court explicitly held that break-up fees paid to white knights in connection with a merger are deductible under section 162, because costs incurred to defend a business from attack are ordinary and necessary expenses.
- b. In TAM 9043003, the Service held that fees incurred to find and merge with a white knight must be capitalized. However, that TAM did not address break-up fees paid to a white knight. In addition, TAM 9144042 seems to have reversed TAM 9043003, although not explicitly.
- c. Even if the Service argues that the break-up fees are not deductible under section 162, however, T should be able to deduct the \$50,000 in break-up fees as a loss under section 165. Expenses incurred by taxpayers in connection with a reorganization that is eventually abandoned are deductible in the year the reorganization is abandoned. Doernbecher, In re Federated supra. But see Part III.F.3., supra.
- d. Note: T would be wise to specifically delineate in its books which funds were paid to W as a result of the break-up and which funds were incurred in assessing P's offers. The Service has noted more than once that the taxpayer must prove that specific funds relate to deductible fees, in order to receive a deduction.
- e. The \$25,000 costs incurred in negotiations with W should be deductible as a loss under section 165 in the year the transaction was abandoned, even if the costs must initially be capitalized as possibly creating a future benefit. See In re Federated, supra. But see Part III.F.3., supra.

B. Example 2

1. Facts: Y is a public corporation. The managers of Y corporation decide to acquire Y. The managers form Newco and Newco Sub (a wholly owned subsidiary of Newco) and make a capital contribution of \$10 million to Newco. Newco Sub borrows \$90 million, to be secured by Y assets. Newco Sub merges into Y in a reverse subsidiary cash merger and Y's public shareholders receive \$100 million for their Y stock. Newco incurs \$500,000 in legal and accounting fees in connection with the merger. Newco Sub incurs \$750,000 in loan fees. It is the Service's position that, to the extent stock is acquired with borrowed funds secured by Y assets, it is treated as a redemption for federal income tax purposes.
2. \$500,000 in Legal and Accounting Fees

- a. Under section 162(k), no deduction is allowed for any amount paid or incurred in connection with the reacquisition of a corporation's stock.
 - (i) Presumably, at least 9/10 of the \$500,000 in reorganization fees, or \$450,000 must be capitalized.
 - (ii) This is because 9/10 of the total acquisition cost is paid out of borrowed funds secured by Y assets, which is treated as a redemption for federal income tax purposes.
- b. The remaining \$50,000 will probably not be deductible under the Hilton and Ellis Banking cases, above, as the expense is allocable to a capital asset. However, there may be some circumstances where the \$50,000 will be deductible, as when such costs relate to severance payments to employees or payments to employees for stock options. See Rev. Ruls. 67-408 and 73-146, supra.

3. \$750,000 in Fees Incurred in Obtaining Loan

- a. A question arises as to whether fees incurred in obtaining a loan in order to redeem stock are sufficiently connected to the redemption in order for section 162(k) to apply.
- b. Section 162(k)(2)(A)(ii) provides that section 162(k) will not apply to amounts properly allocable to indebtedness and amortized over the term of such indebtedness.
- c. Thus, the \$750,000 in loan fees is deductible if Newco Sub amortizes that amount over the term of the loan. For prior law, see In re Kroy and Fort Howard, supra.

C. Example 3

- 1. Facts: X corporation makes a tender offer to the shareholders of Y corporation, after accumulating a significant amount of Y stock. The fair market value of X's Y stock prior to the tender offer is \$10,000,000. The board of directors of Y, attempting to avert a hostile takeover, offers to buy X's shares in Y for \$15,000,000. X accepts. In order to raise the funds necessary to purchase X's Y stock, Y obtains a loan from a bank, and incurs \$500,000 in investment banking fees, credit arrangement fees, closing fees, bank agent fees, and legal fees.
- 2. \$15,000,000 Payment to X to Redeem Y Stock
 - a. Under section 162(k), no deduction is allowed for any amount paid or incurred in connection with the reacquisition of corporate stock.

- b. The legislative history of section 162(k) explicitly states that amounts included under section 162(k) include amounts paid to repurchase stock and fees incurred in connection with such repurchase. See H.R. Rep. No. 426 and S. Rep. No. 313, supra.
- c. Although Y may argue that the \$5,000,000 premium paid to X above the fair market value of the stock should be deductible, the Service noted in its ISP Paper that costs associated with greenmail must be capitalized, even if the purchase price includes a premium. ISP Paper, supra.
- d. Thus, the \$15,000,000 greenmail payment to X in all likelihood must be capitalized.

3. \$500,000 Fees Incurred in Obtaining Loan

- a. Although section 162(k) provides that all costs paid or incurred in connection with the reacquisition of a corporation's stock must be capitalized, a question arises as to whether fees incurred in obtaining a loan in order to redeem stock are sufficiently connected to the redemption in order for section 162(k) to apply.
- b. This issue is substantially the same issue as in Example 2. Because section 162(k)(2)(A)(ii) provides that section 162(k) will not apply to amounts properly allocable to indebtedness and amortized over the term of such indebtedness, the \$500,000 in loan fees is deductible if amortized over the term of the loan. For prior law, see In re Kroy and Fort Howard, *supra*.

* * *

PART TWO -- THE SECTION 263(a) REGULATIONS

I. BACKGROUND TO THE SECTION 263(a) REGULATIONS

A. Public Comments on INDOPCO

1. In January of 1996, the Service invited the public to comment on the approaches it should consider in addressing issues under section 162 and section 263 in light of INDOPCO. Notice 96-7, 1996-1 C.B. 359 (Jan. 18, 1996).
2. Numerous commentators urged the Service to provide general guidance on capitalization issues, rather than providing piecemeal guidance over time through the issuance of private letter rulings. See, e.g., Comment of Tax Executives Institute, 96 TNT 60-19; Comment of American Bar Association Section of Taxation, 96 TNT 104-71; Comment of National Retail Federation, 96 TNT 127-21; Comment of American Bankers Association, 96 TNT 98-28; and Comment of Financial Executives Institute, 96 TNT 120-19, among others.
3. The Service placed capitalization issues on its 2001 Business Plan, which included “proposed regulations under sections 162 and 263 regarding deduction and capitalization of expenditures.” See Notice, 2001 FED ¶ 46,425 (CCH) (Apr. 26, 2001).

B. The Advance Notice of Proposed Rulemaking (the “Advance Notice”)

1. The Advance Notice

- a. On February 17, 2002, the Service issued an Advance Notice of Proposed Rulemaking (the “Advance Notice”) describing the regulations that it intended to propose in 2002 regarding the capitalization of costs incurred in acquiring, creating, or enhancing intangible assets. Announcement 2002-9, 2002-1 C.B. 536 (Feb. 17, 2002). Section C of the Advance Notice relates to the capitalization of transaction costs.
- b. The Advance Notice states that the Service believes that the results reached by the courts in capitalization cases regarding intangible assets are often difficult to reconcile and have created uncertainty and controversy. In addition, the Advance Notice states that the current level of uncertainty and controversy is neither fair to taxpayers nor consistent with sound and efficient tax administration. Moreover, the Advance Notice states that the purpose of the proposed regulations is to clarify the application of section 263(a) and define the specific categories of expenditures incurred in acquiring, creating, or enhancing intangible assets or benefits that taxpayers are required to capitalize.
- c. The Advance Notice states that the Service expects to propose a rule that would require taxpayers to capitalize certain transaction costs that facilitate the taxpayer’s acquisition, creation, restructuring, or reorganization of a business entity, an applicable asset acquisition within the meaning of section 1060(c), or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.
- d. The Advance Notice clarifies that the proposed rule will not require the following transactional costs to be capitalized:
 - (i) Employee compensation (except for bonuses and commissions that are paid with respect to the transaction);
 - (ii) Fixed overhead; and
 - (iii) De minimis costs.
 - (a) The Advance Notice implies that the threshold for the de minimis exception will be \$5,000.
 - (b) However, the Advance Notice gives no indication of how to compute the \$5,000 amount (e.g., cost-

by-cost or aggregating all costs) and what costs may be accounted for under the de minimis exception.

- e. The Advance Notice also states that, in addition to the exceptions listed above, the Service is considering alternative approaches for excepting certain transaction costs from capitalization. The express purpose of these alternative approaches is to ease the administrative burden of accounting for transaction costs and to minimize the uncertainty surrounding what costs properly fall under the exceptions. For example, the Advance Notice states that the Service may propose a rule that excepts all employee compensation (including commissions and bonuses paid in connection with the capital transaction) from capitalization to the extent such compensation is a regular and recurring expense of the taxpayer. The Advance Notice further states that the Service is considering whether a taxpayer's financial or regulatory accounting treatment of costs should in any way determine whether that cost is capitalized or deducted.
- f. The Advance Notice clarifies that the proposed rule will be limited to costs incurred in facilitating an acquisition. Thus, taxpayers will not be required to capitalize post-acquisition costs (such as integration costs or severance payments made to employees) because such costs do not facilitate the acquisition.
- g. The Advance Notice also states that the Service intends to propose rules for the capitalization of costs relating to the acquisition of financial interests or intangible property from another person, and rules for the capitalization of costs relating to amounts paid to create or enhance certain intangible rights or benefits, including prepaid items, market entry payments, rights from a government agency, obtaining, modifying and terminating contractual rights, payments that facilitate the use of another's intangible property, and payments to perfect or defend title to intangible property. However, these costs are outside the scope of this outline.
- h. The Advance Notice has no substantive effect. However, its issuance did prompt the IRS to issue two memoranda and one notice providing guidance to IRS personnel regarding the treatment (on audit and in issuing guidance to taxpayers) of section 263(a) issues on a prospective basis. These notices are discussed immediately below.

2. Effect of the Advance Notice on Current Audits and Litigation

- a. On February 26, 2002, the Service issued a memorandum to Large and Mid-Sized Business (“LMSB”) and Small Business/ Self-Employed (“SBSE”) Division employees regarding the Proposed Rulemaking. 2002 ARD 046-11. The Memorandum states that the rules and standards in the Advance Notice are not the Service’s position and do not provide any authority for the concession of capitalization issues, and that standard examination practices and procedures for resolution of such issues should generally remain unchanged despite the Advance Notice.
- b. On March 19, 2002, the Office of Chief Counsel issued a notice to all IRS employees announcing a change in the Service’s litigating position. CC-2002-021 (Mar. 19, 2002). The Notice states that it is an inefficient use of resources to litigate certain transaction cost issues while the Service is in the process of proposing regulations that may ultimately allow a current deduction for such costs. In addition, the Notice states that the Service will not assert in litigation that certain employee compensation, fixed overhead, or de minimis transaction costs (costs that do not exceed \$5,000) must be capitalized under section 263(a).
- c. On April 26, 2002, the Service issued a second memorandum to LMSB and SBSE employees regarding the effect of CC-2002-021 and the Proposed Rulemaking on current and future audits and examinations. 2002 ARD 091-3. The memorandum concludes that examiners should not propose capitalization under section 263(a) for employee compensation (except for bonuses and commissions that are paid with respect to the transaction unless they fall within the de minimis threshold), fixed overhead, or de minimis transaction costs (as defined in CC-2002-021) related to the acquisition, creation or enhancement of intangible capital assets.

C. The Proposed Section 263(a) Regulations (the “Proposed Regulations”)

1. On December 19, 2002, the Service issued a Notice of Proposed Rulemaking, Reg. 125638-1 (December 19, 2002) (the “Proposed Regulations”), that set forth rules regarding when taxpayers must capitalize costs incurred with respect to intangible assets and capital transactions. The Proposed Regulations do not provide rules for the treatment of costs related to tangible assets.

2. The Proposed Regulations are generally effective for amounts paid or incurred on or after the date upon which the Proposed Regulations are finalized and published in the Federal Register. Prop. Treas. Reg. § 1.263(a)-4(o).

D. The Final Section 263(a) Regulations (the “Final Regulations”)

1. On December 31, 2003, the Service issued Final Regulations, T.D. 9107, adopting the Proposed Regulations with a few revisions. The Final Regulations set forth rules regarding when taxpayers must capitalize costs incurred with respect to intangible assets and capital transactions. Unlike the Proposed Regulations, the Final Regulations do provide rules for the treatment of costs related to tangible assets.
 - a. Note: On August 18, 2006, the Treasury Department and Service issued proposed regulations that clarify the treatment of expenditures incurred in selling, acquiring, producing or improving tangible assets. The proposed regulations on tangible assets clarify and expand section 263(a) standards and provide bright-line tests. However, the proposed regulations do not address amounts paid to facilitate an acquisition of a trade or business because those items are addressed in § 1.263(a)-5 of the Final Regulations.
2. The Final Regulations are intended to clarify, simplify, and replace the often inconsistent authorities that traditionally have governed the treatment of costs incurred with respect to intangible assets, as well as those authorities (discussed above in Part One) that govern transaction costs incurred in connection with reorganizations, restructurings, and transactions involving the acquisition of capital. In addition, the Final Regulations are intended to promote and ensure the consistent interpretation of section 263(a) (as that section relates to transactions involving intangible assets) by taxpayers and IRS personnel, by providing a comprehensive set of rules for the capitalization of such costs.
3. The rules contained in the Final Regulations should diminish the applicability of the authorities discussed in Part One of this outline regarding the treatment of reorganization costs. However, the scope of the Final Regulations is not limited to the treatment of reorganization costs. The Final Regulations also provide rules that govern the treatment of direct and indirect costs incurred to acquire and create intangible assets.
4. This outline concerns the treatment of reorganization costs. Accordingly, most of the following discussion regarding the Final Regulations relates to those provisions that address this issue. See Treas. Reg. §§ 1.263(a)-5(a)(1)(iii), -5(n). However, for the sake of clarity and completeness, this outline also will provide a brief overview of the organizational structure of

the Final Regulations and briefly discuss the rules that govern the direct and indirect costs of acquiring or creating intangible assets.

II. GENERAL DISCUSSION OF THE FINAL REGULATIONS -- TREAS. REG. §§ 1.263(A)-4 AND 1.263(A)-5

A. Organization of the Final Regulations

1. The final regulations set forth in Treas. Reg. § 1.263(a)-4 the rules requiring capitalization of⁸
 - a. Amounts paid to acquire or create intangibles; and
 - b. Amounts paid to facilitate the acquisition or creation of intangibles.
 - (i) Note: The final regulations eliminate the word “enhance” from the proposed regulations with respect to portions of the general principle. Commentators expressed concerns that the use of the term “enhance” would require capitalization in unintended circumstances. Preamble, T.D. 9107.
2. The final regulations set forth in Treas. Reg. § 1.263(a)-5 the rules requiring capitalization of amounts paid to facilitate a “restructuring or reorganization of a business entity or a transaction involving the acquisition of capital, including a stock issuance, borrowing, or recapitalization.” Preamble, T.D. 9107.
 - a. Note: The proposed regulations included this rule in Treas. Reg. § 1.263(a)-4. Preamble, T.D. 9107.

B. Overview of Treas. Reg. § 1.263(a)-4 -- Intangibles

1. Amounts Paid to Acquire or Create Intangibles
 - a. A taxpayer must capitalize the following, with respect to intangibles:
 - (i) Acquired Intangibles. A taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Treas. Reg. §

⁸ Treas. Reg. §§ 1.263(a)-4(b)(1)(iii) and (iv) also require the capitalization of amounts paid to create or enhance a separate and distinct intangible asset, as well as amounts paid to create or enhance a future benefit identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalization is required, respectively.

1.263(a)-4(c). Examples of intangibles include the following:

- (a) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity;
- (b) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes;
- (c) Financial instruments, such as a notional principal contract, a foreign currency contract, a futures contract, a forward contract, an option, and any other financial derivative;
- (d) An endowment contract, annuity contract, or insurance contract;
- (e) Non-functional currency;
- (f) A lease;
- (g) A patent or copyright;
- (h) A franchise, trademark or trade name (as defined in § 1.197-2(b)(10));
- (i) An assembled workforce (as defined in § 1.197-2(b)(3));
- (j) Goodwill (as defined in § 1.197-2(b)(1)) or going concern value (as defined in § 1.197-2(b)(2));
- (k) A customer list;
- (l) A servicing right (e.g., a mortgage servicing right that is not treated for federal income tax purposes as a stripped coupon);
- (m) A customer-based intangible (as defined in § 1.197-2(b)(6)) or supplier-based intangible (as defined in § 1.197-2(b)(7));
- (n) Computer software;

- (o) An agreement providing either party the right to use, possess or sell an intangible described above ((a)-(e));
- (ii) Created Intangibles. Except as provided by the “12-month rule” exception (see Part II. B. 3.), a taxpayer must capitalize amounts paid to create an intangible. Treas. Reg. § 1.263(a)-4(d). The eight categories of created intangibles remain the same as those listed in the proposed regulations. Treas. Reg. § 1.263(a)-4(d)(2) - (9). However, the final regulations contain a rule providing that the determination of whether an amount is paid to create an intangible identified in the final regulations is made based on all of the facts and circumstances, disregarding distinctions between the labels used in the regulations to describe the intangible and the labels used by the taxpayer and other parties to describe the transaction.

The eight categories of created intangibles are:

- (a) Financial Interests - a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the following financial interests, whether or not the interest is regularly traded on an established market:
 - i) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity;
 - ii) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMC or FASIT, or any other intangible treated as debt for federal income tax purposes;
 - iii) A financial instrument, such as a letter of credit, a credit card agreement, a notional principal contract, a foreign currency contract, a futures contract, a forward contract, an option contract and any other financial derivative;
 - a) Note: The final regulations eliminated the rule contained in

Prop. Treas. Reg. § 1.263(a)-4(d)(2)(ii) providing that capitalization is not required for an amount paid to create or originate an option or forward contract if the amount is allocable to property required to be provided or acquired by the taxpayer prior to the end of the taxable year in which the amount is paid.

This rule was unnecessary and was incorrectly read by some commentators to suggest that taxpayers could immediately deduct amounts paid to create or originate an option or forward contract. Preamble, T.D. 9107.

- iv) An endowment contract, annuity contract, or insurance contract that has or may have cash value;
 - v) Non-functional currency; and
 - vi) An agreement providing either party the right to use, possess or sell a financial interest described in the above (1)-(5).
- (b) Prepaid Expenses;
 - (c) Certain Memberships and Privileges;
 - (d) Certain Rights Obtained from a Governmental Agency;
 - (e) Certain Contract Rights;
 - i) Note: Unlike the proposed regulations, the final regulations address the concern that capitalization is not appropriate if the taxpayer has only a hope or expectation that a customer or supplier will begin or continue a business relationship with the taxpayer. Preamble, T.D. 9107.
 - (f) Certain Contract Terminations;

- (g) Benefits Arising From the Provision, Production, or Improvement of Real Property; and
- (h) Defense or Perfection of Title to Intangible Property.

2. Amounts Paid to Facilitate the Acquisition or Creation of Intangibles

- a. A taxpayer must capitalize an amount paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction (except as provided by the “12-month rule” exception as to facilitating the creation of an intangible (see Part II. B. 3.)). Treas. Reg. § 1.263(a)-4(e).
 - (i) “Facilitate” Defined. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. Treas. Reg. § 1.263(a)-4(e)(1)(i).
 - (a) Note: The proposed regulations provided that, in determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid “but for” the transaction is “not relevant.” The IRS and Treasury Department believe it is a relevant factor, but not the only factor, and the final regulations reflect this belief.
 - (b) The proposed regulations also applied the “facilitate” standard to divisive transactions, which is now discussed in Treas. Reg. § 1.263(a)-5 (see Part III. A.).
 - (c) Treatment of Termination Payments in Integrated Transactions. An amount paid to terminate (or facilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement. Treas. Reg. § 1.263(a)-4(e)(1)(ii).
 - i) Note: The final regulations eliminate the rule in the proposed regulations that treats amounts paid to terminate (or facilitate the termination of) an existing agreement as facilitating another transaction that is expressly conditioned on the termination of

the agreement. The IRS and Treasury Department decided that well advised taxpayers could easily avoid the rule by using general representations, while uninformed taxpayers could be caught by the rule. Preamble, T.D. 9107.

(d) Non-Facilitative Costs. The following costs do not facilitate the acquisition or creation of an intangible:

- i) Employee Compensation;
- ii) Overhead; and
- iii) De Minimis Costs. Treas. Reg. § 1.263(a)-4(e)(4)(i)-(iii).
 - a) De minimis costs are defined as amounts paid in the process of investigating or otherwise pursuing a transaction if, in the aggregate, the amounts do not exceed \$5,000. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A).
 - b) If the amounts exceed \$5,000, none of the amounts are de minimis costs. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A).
 - c) An amount paid in the form of property is valued at its fair market value at the time of the payment. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A).
 - i. Note: The final regulations added the above rule for purposes of determining whether a transaction cost paid in the form of property is de minimis. Preamble, T.D. 9107.
 - d) Rather than determining the amount of transaction costs by reference to the actual amount paid with respect to the transaction, taxpayers may

elect to calculate transaction costs under the average cost pooling method. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A). For more information regarding the average cost pooling method, see Treas. Reg. § 1.263(a)-4(g)(4).

e) Election to Capitalize. A taxpayer may elect to treat employee compensation, overhead, or de minimis costs paid in the process of investigating or otherwise pursuing a transaction as amounts that facilitate the transaction.

i. Note: The final regulations added this election.
Preamble, T.D. 9107.

b. “Amount Paid in the Process of Investigating or Otherwise Pursuing the Transaction” Defined. An amount paid to determine the value or price of an intangible. Treas. Reg. § 1.263(a)-4(e)(1)(i).

(i) Special Rule for Contracts. An amount is treated as not paid in the process of investigating or otherwise pursuing the creation of an agreement if the amount relates to activities performed before the earlier of:

(a) the date the taxpayer begins preparing its bid for the agreement; or

(b) the date the taxpayer begins discussing or negotiating the agreement with another party to the agreement.

i) Note: This special rule in the final regulations addressed the concern that the proposed regulations rule requiring taxpayers to capitalize amounts paid in the process of pursuing certain agreements could be interpreted very broadly.
Preamble, T.D. 9107.

c. “Transaction” Defined. The term transaction means all of the factual elements comprising an acquisition or creation of an intangible and includes a series of steps carried out as part of a

single plan. Thus, a transaction can involve more than one invoice and more than one intangible. Treas. Reg. § 1.263(a)-4(e)(3).

3. 12-Month Rule Exception. Taxpayers are not required to capitalize amounts paid to create (or to facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of:
 - a. 12 months after the first date on which the taxpayer realizes the right or benefit; or
 - b. The end of the taxable year following the taxable year in which the payment is made. Treas. Reg. § 1.263(a)-4(f)(1)(i) and (ii)
 - (i) Election to Capitalize. A taxpayer may elect not to apply the 12-month rule exception under Treas. Reg. § 1.263(a)-4(f)(1). A taxpayer makes the election by treating the amounts as capital expenditures in its timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. Treas. Reg. § 1.263(a)-4(f)(7).
 - (a) Note: The IRS and Treasury Department recognize that some taxpayers may capitalize amounts for financial accounting purposes that would not be required to be capitalized for federal income tax purposes due to the 12-month rule. In some cases, it may be difficult for taxpayers to identify and calculate these amounts for purposes of applying the 12-month rule. For this reason, the final regulations permit taxpayers to elect to capitalize these amounts notwithstanding that the 12-month rule would not require capitalization. Preamble, T.D. 9107.

III. FINAL TREAS. REG. § 1.263(A)-5: AMOUNTS PAID OR INCURRED TO FACILITATE AN ACQUISITION OF A TRADE OR BUSINESS, A CHANGE IN THE CAPITAL STRUCTURE OF A BUSINESS ENTITY, AND CERTAIN OTHER TRANSACTIONS

- A. Facilitations Requiring Capitalization. A taxpayer must capitalize amounts paid to facilitate certain transactions (see subsections “a” through “j” listed below), without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction. Treas. Reg. § 1.263(a)-5(a).
 1. Transactions Defined. The following are “transactions” under Treas. Reg. § 1.263(a)-5:

- a. An acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition). Treas. Reg. § 1.263(a)-5(a)(1).
 - (i) Note: The proposed regulations only applied to amounts paid to acquire (or facilitate the acquisition of) intangible assets acquired as a part of a trade or business and did not apply to amounts paid to acquire (or facilitate the acquisition of) tangible assets acquired as part of a trade or business. The final regulations under § 1.263(a)-5 provides a single set of rules for amounts paid to facilitate an acquisition of a trade or business, regardless of whether the transaction is structured as an acquisition of the entity or as an acquisition of assets (including tangible assets) constituting a trade or business. Preamble, T.D. 9107.
 - (ii) Note: On March 10, 2008, the Treasury Department and Service issued proposed regulations that clarify the treatment of expenditures incurred in selling, acquiring, producing or improving tangible assets. The proposed regulations do not address amounts paid to facilitate an acquisition of a trade or business because those items are covered by § 1.263(a)-5. Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 73 Fed. Reg. 12838 (Mar. 10, 2008).
- b. An acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and business entity are related within the meaning of section 267(b) or 707(b). Treas. Reg. § 1.263(a)-5(a)(2).
- c. An acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise). Treas. Reg. § 1.263(a)-5(a)(3).
- d. A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in section 368 and distributions of stock by the taxpayer as described in section 355). Treas. Reg. § 1.263(a)-5(a)(4).
- e. A transfer described in section 351 or section 721 (whether the taxpayer is the transferor or transferee). Treas. Reg. § 1.263(a)-5(a)(5).
- f. A formation or organization of a disregarded entity. Treas. Reg. § 1.263(a)-5(a)(6).

- g. An acquisition of capital. Treas. Reg. § 1.263(a)-5(a)(7).
- h. A stock issuance. Treas. Reg. § 1.263(a)-5(a)(8).
- i. A borrowing (i.e., any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization and debt issued in a debt for debt exchange under § 1.1001-3). Treas. Reg. § 1.263(a)-5(a)(9).
- j. Writing an option. Treas. Reg. § 1.263(a)-5(a)(10).

2. “Facilitate”

- a. Defined. An amount is paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Treas. Reg. § 1.263(a)-5(b)(1).

- (i) “Paid to Facilitate a Transaction”

- (a) The fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. Treas. Reg. § 1.263(a)-5(b)(1).

- i) Note: The proposed regulations provided that, in determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid “but for” the transaction was “not relevant.” The IRS and Treasury Department believe it is a relevant factor, but not the only factor, and the Final Regulations reflect this belief. Preamble, T.D. 9107.

- (b) An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange (e.g., the purchase price paid to the target of an asset acquisition in exchange for its assets is not an amount paid to facilitate the acquisition). Treas. Reg. § 1.263(a)-5(b)(1).

- (c) Documentation of Success-Based Fees. An amount paid that is contingent on the successful closing of a transaction is an amount paid to facilitate the transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do

not facilitate the transaction. Treas. Reg. § 1.263(a)-5(f). Rev. Proc. 2011-29 provides a safe harbor election for these payments which reduces the documentation requirements. *See infra* Part II Section IV.

- i) Documentation Requirements. The documentation:
 - a) Must be completed on or before the due date of the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the transaction closes. Treas. Reg. § 1.263(a)-5(f).
 - b) Must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction. Treas. Reg. § 1.263(a)-5(f).
 - c) Must consist of supporting records (e.g., time records, itemized invoices, or other records) that identify:
 - i. The various activities performed by the service provider (Treas. Reg. § 1.263(a)-5(f)(1));
 - ii. The amount of the fee (or percentage of time) that is allocable to each of the various activities performed (Treas. Reg. § 1.263(a)-5(f)(2));
 - iii. Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time)

that is allocable to the performance of that activity before and after the relevant date (Treas. Reg. § 1.263(a)-5(f)(3)); and

- iv. The name, business address, and business telephone number of the service provider (Treas. Reg. § 1.263(a)-5(f)(4)).

(1) Note: Under the proposed regulations, the success-based fee rule was limited to acquisitions and the evidence required was subject to a “clearly demonstrates” standard. The final regulations extend the rule to all transactions to which Treas. Reg. § 1.263(a)-5 applies, instead of just acquisitive transactions, and eliminates the “clearly demonstrates” standard. Preamble, T.D. 9107.

(ii) “Paid in the Process of Investigating or Otherwise Pursuing the Transaction”

- (a) This standard is determined based on all of the facts and circumstances. Treas. Reg. § 1.263(a)-5(b)(1).
- (b) An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. Treas. Reg. § 1.263(a)-5(b)(1).

b. “Facilitate” in the Context of Covered Transactions

(i) Covered Transactions Defined. The term “covered transaction” means the following transactions:

- (a) A taxable acquisition by the taxpayer of assets that constitute a trade or business;

- (b) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b) of the code; and
 - (c) A reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization). Treas. Reg. § 1.263(a)-5(e)(3).
- (ii) General Rule. An amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction facilitates the transaction (resulting in capitalization) only if the amount relates to activities performed on or after the earlier of:
- (a) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or
 - (b) One of the following:
 - i) The date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors); or
 - ii) In the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. Treas. Reg. § 1.263(a)-5(e)(1).
 - a) In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors

(or appropriate governing officials in the case of a taxpayer that is not a corporation), the date is the one on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction. Treas. Reg. § 1.263(a)-5(e)(1).

- b) Note: The final regulations modify the bright line date rule provided in the proposed regulations by adding the case of a transaction that does not require authorization or approval. Preamble, T.D. 9107.

(iii) Exception for Inherently Facilitative Amounts

- (a) Regardless of whether the amount is paid for activities performed prior to the date determined above (see general rule), a payment is inherently facilitative if it is paid for:
 - i) Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;
 - ii) Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (e.g., obtaining tax advice on the application of section 368);
 - iii) Preparing and reviewing the documents that effectuate the transaction (e.g., a merger agreement or purchase agreement);
 - iv) Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;
 - v) Obtaining shareholder approval of the transaction (e.g., proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or
 - vi) Conveying property between the parties to the transaction (e.g., transfer taxes and title

registration costs). Treas. Reg. § 1.263(a)-5(e)(2)(i)-(vi).

- a) Note: the Final Regulations modify the list of inherently facilitative amounts to more clearly identify the types of costs considered inherently facilitative. Preamble, T.D. 9107.

B. Treatment of Capitalized Costs

1. Taxable Acquisitive Transactions

- a. The Acquirer. In the case of an acquisition, merger, or consolidation that is not described in section 368, an amount required to be capitalized by the acquirer is treated the following ways:
 - (i) Asset Acquisition. If the transaction is treated as an acquisition of the assets of the target for federal income tax purposes, then the amount is added to the basis of the acquired assets.
 - (ii) Stock Acquisition. If the transaction is treated as an acquisition of the stock of the target for federal income tax purposes, then the amount is added to the basis of the acquired stock. Treas. Reg. § 1.263(a)-5(g)(2)(i).
- b. The Target. In the case of an acquisition, merger, or consolidation that is not described in section 368, an amount required to be capitalized by the target is treated the following way:
 - (i) Asset Acquisition. If the transaction is treated as an acquisition of the assets of the target for federal income tax purposes, then the amount is treated as a reduction of the target's amount realized on the disposition of its assets. Treas. Reg. § 1.263(a)-5(g)(2)(ii)(A).

2. Tax-Free Transactions, Costs of a Target in a Taxable Stock Acquisition and Stock Issuance Costs

- a. General. The final regulations do not address the treatment of amounts required to be capitalized in certain other transactions to which Treas. Reg. § 1.263(a)-5 applies (e.g., amounts required to be capitalized in tax-free transactions, costs of a target in a taxable stock acquisition and stock issuance costs). The IRS and Treasury Department intend to issue separate guidance to address the treatment of these amounts and will consider at that time whether

such amounts should be eligible for the 15-year safe harbor amortization period described in Treas. Reg. § 1.167(a)-3. See Notice 2004-18, I.R.B. 2004-11 (February 19, 2004).

- b. Specific Transactions. The IRS and Treasury Department are considering the treatment of capitalized costs that facilitate the following transactions:
- (i) Tax-free asset acquisitions and dispositions (e.g., reorganizations under section 368(a)(1)(A), (C), (D), (G));
 - (ii) Taxable asset acquisitions and dispositions (see Treas. Reg. § 1.263(a)-5(g) for the treatment of certain transaction costs in taxable asset acquisitions);
 - (iii) Tax-free stock acquisitions and dispositions (e.g., reorganizations under section 368(a)(1)(B));
 - (iv) Taxable stock acquisitions and dispositions (see Treas. Reg. § 1.263(a)-5(g) for the treatment of certain transaction costs in taxable stock acquisitions);
 - (v) Tax-free distributions of stock (e.g., distributions of stock to which section 305(a) or section 355(a) applies);
 - (vi) Tax-free distributions of property (e.g., distributions to which sections 332 and 337 apply);
 - (vii) Taxable distributions of property (e.g., distributions to which sections 331 and 336 apply and distributions of stock to which section 311 applies);
 - (viii) Organizations of corporations, partnerships, and entities that are disregarded as separate from their owner (e.g., transfers described in section 351 or section 721);
 - (ix) Corporate recapitalizations (e.g., reorganizations under section 368(a)(1)(E));
 - (x) Reincorporations of corporations in a different state (e.g., in a reorganization under section 368(a)(1)(F)); and
 - (xi) Issuances of stock.
- c. Comments Requested. The IRS and Treasury Department are requesting comments on the following issues:
- (i) Treatment of Capitalized Costs

- (a) The Service and Treasury Department are seeking guidance as to whether the particular capitalized costs that facilitate the transactions listed in Section III, Part B, subsection 2. b., above should:
 - i) increase the basis of a particular asset or assets (and if the basis of multiple assets should be increased, the methodology for allocating the costs among the assets);
 - ii) be treated as giving rise to a new asset the basis of which may not be amortized;
 - iii) be treated as giving rise to a new asset the basis of which may be amortizable;
 - iv) reduce an amount realized; or
 - v) be treated as an adjustment to equity.
 - (b) The Service and Treasury Department are seeking guidance as to what the appropriate amortizable useful life should be if the capitalized costs are treated as giving rise to a new asset.
 - (ii) Consistency of Treatment
 - (a) Consistency With Costs that Facilitate Similar Taxable and Tax-Free Transactions. The Service and Treasury Department are seeking guidance as to whether, as a public policy matter, capitalized costs that facilitate a tax-free transaction should be treated in the same manner as the capitalized costs that facilitate a similar taxable transaction.
 - (b) Consistency With Costs that Facilitate a Transaction. The Service and Treasury Department are seeking guidance as to whether, as a policy matter, capitalized costs that facilitate a transaction, regardless of the type of cost and the party to the transaction that incurs such cost, should be treated similarly. Notice 2004-18, I.R.B. 2004-11 (February 19, 2004).
3. Treatment of Capitalized Amounts by Option Writer. The amount required to be capitalized generally reduces the total premium received by an option writer. However, other provisions of law may limit the reduction of the premium by the capitalized amount (e.g., if the capitalized

amount is never deductible by the option writer). Treas. Reg. § 1.263(a)-5(g)(5).

- a. Note: As discussed in Part A., subsection 1., a taxpayer must capitalize amounts paid to facilitate certain transactions. Those transactions include writing an option.

C. Costs Not Capitalized

1. Special Rules for Certain Costs

- a. Borrowing Costs. An amount paid to facilitate a borrowing does not facilitate another transaction. Treas. Reg. §1.263(a)-5(c)(1);
- b. Costs of Asset Sales. An amount paid by a taxpayer to facilitate a sale of its assets does not facilitate another transaction (e.g., where a target corporation, in preparation for a merger with an acquiring corporation, sells assets that are not desired by the acquiring corporation, amounts paid to facilitate the sale of the unwanted assets are not required to be capitalized as amounts paid to facilitate the merger). Treas. Reg. §1.263(a)-5(c)(2);
 - (i) Note: The final regulations modify the rule in the proposed regulations, which required capitalization of amounts paid to facilitate a sale of assets where the sale is required by law, regulatory mandate, or court order and the sale itself facilitates another capital transaction. Preamble, T.D. 9107.
- c. Mandatory Stock Distributions. An amount paid in the process of investigating or otherwise pursuing a distribution of stock by a taxpayer to its shareholders does not facilitate a transaction if the divestiture of the stock (or of properties transferred to an entity whose stock is distributed) is required by law, regulatory mandate, or court order. Treas. Reg. §1.263(a)-5(c)(3);
 - (i) Note: The final regulations eliminate the exception in the Proposed Regulations, which provided that if the divestiture facilitated another capital transaction, then the amount should be capitalized. Preamble, T.D. 9107.
- d. Bankruptcy Reorganization Costs
 - (i) Facilitates (Capitalized)
 - (a) An amount paid to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code by a taxpayer that is the debtor under the

proceeding constitutes an amount paid to facilitate a reorganization, regardless of the purpose for which the proceeding is instituted.

(ii) Does Not Facilitate (Not Capitalized)

- (a) An amount paid to formulate, analyze, contest or obtain approval of a plan of reorganization under Chapter 11 that resolves tort liabilities of the taxpayer do not facilitate a reorganization if the amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted.
- (b) An amount paid by the taxpayer to defend against the commencement of an involuntary bankruptcy proceeding against the taxpayer does not facilitate a reorganization.
- (c) An amount paid by the debtor to operate its business during a Chapter 11 bankruptcy proceeding is not an amount paid to institute or administer the bankruptcy proceeding and does not facilitate a reorganization. Treas. Reg. §1.263(a)-5(c)(4);

- e. Stock Issuance Costs of Open-End Regulated Investment Companies. Amounts paid by an open-end regulated investment company (within the meaning of section 851) to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction unless the amounts are paid during the initial stock offering period. Treas. Reg. §1.263(a)-5(c)(5);
- f. Integration Costs. An amount paid to integrate the business operations of the taxpayer with the business operations of another does not facilitate a transaction regardless of when the integration activities occur. Treas. Reg. § 1.263(a)-5(c)(6);
- g. Registrar and Transfer Agent Fees for the Maintenance of Capital Stock Records. An amount paid by a taxpayer to a registrar or transfer agent in connection with the transfer of the taxpayer's capital stock does not facilitate a transaction unless the amount is paid with respect to a specific transaction. Treas. Reg. §1.263(a)-5(c)(7); and
- h. Termination Payments and Amounts Paid to Facilitate Mutually Exclusive Transactions

- (i) Termination Payments. An amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction constitutes an amount paid to facilitate a second transaction only if the transactions are mutually exclusive. Treas. Reg. §1.263(a)-5(c)(8).
 - (a) Note: Under the proposed regulations, termination costs facilitate a subsequent transaction if the subsequent transaction is “expressly conditioned” on the termination. The Final Regulations eliminated the “expressly conditioned” rule. Preamble, T.D. 9107.
 - (b) Note: As discussed in Part One, Section II, a bankruptcy court in the Southern District of Ohio held in In re Federated that if there are two mutually exclusive transactions, only one of which the taxpayer could undertake, the taxpayer may deduct the fees associated with whichever transaction the taxpayer abandons, under section 165. Under the final regulations, however, the taxpayer may not deduct a termination fee associated with an abandoned transaction if the transactions are mutually exclusive. The taxpayer must capitalize the fee. See TAM 9402004; TAM 200512021; TAM 200521032, all discussed supra at Part One, Section II.
 - (ii) Facilitative Payments. An amount paid to facilitate a transaction is treated as an amount paid to facilitate a second transaction only if the transactions are mutually exclusive. Treas. Reg. §1.263(a)-5(c)(8).
 - i. Note: The IRS and Treasury Department decided that the rules in the proposed regulations for amounts paid to defend against a hostile takeover attempt are unnecessary. The hostile transaction rule in the proposed regulations did not permit taxpayers to deduct costs that otherwise would have been capitalized under the regulations. For example, the hostile transaction rule does not apply to any inherently facilitative costs or to costs that facilitate another transaction (e.g., a recapitalization or a proposed merger with a white knight). Preamble, T.D. 9107.
2. Non-Facilitative Costs. The following costs do not facilitate the acquisition or creation of an intangible:
- a. Employee Compensation;

- b. Overhead; and
- c. De Minimis Costs. Treas. Reg. § 1.263(a)-4(e)(4)(i)-(iii).
 - (i) De minimis costs are defined as amounts paid in the process of investigating or otherwise pursuing a transaction if, in the aggregate, the amounts do not exceed \$5,000. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A).
 - (ii) If the amounts exceed \$5,000, none of the amounts are de minimis costs. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A).
 - (iii) An amount paid in the form of property is valued at its fair market value at the time of the payment. Treas. Reg. § 1.263(a)-4(e)(4)(iii)(A).
 - (a) Note: The final regulations added the above rule for purposes of determining whether a transaction cost paid in the form of property is de minimis. Preamble, T.D. 9107.
 - (iv) De minimis costs do not include commission paid to facilitate a transaction.
 - (v) Election to Capitalize. A taxpayer may elect to treat employee compensation, overhead, or de minimis costs paid in the process of investigating or otherwise pursuing a transaction as amounts that facilitate the transaction. Treas. Reg. § 1.263(a)-5(d)(4).
 - (a) Note: The final regulations added this election. Preamble, T.D. 9107.

IV. CASES AND RULINGS

- A. Rev. Proc. 2011-29; 2011-18 IRB 746 – Provides a safe harbor election for allocating success-based fees paid in covered transactions. This allows taxpayers to forgo the documentation requirement of Treas. Reg. § 1.263(a)-5(f). The safe harbor allows electing taxpayers to treat 70 percent of the success-based fee as an amount that does not facilitate the transaction. The remaining 30 percent must be capitalized under section 263. To make the election taxpayers must attach a statement to their tax return stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted and capitalized. This is effective for success-based fees paid in tax years ending after April 7, 2011.

- B. Media Space Inc. v. Comm’r, 135 TC 21 (2010) – Forbearance payments made to defer the redemption of stock by investors were payments to modify a financial interest under 1.263(a)-4(d)(2)(i) and had to be capitalized.
- C. PLR 200953014 (September 15, 2009) Provides guidance on when a company can account for transaction costs and provider fees in connection with a completed merger. Finds that transaction costs can be accounted for under Treas. Reg. § 1.263(a) when the company demonstrates that services were rendered to or on behalf of the company and when fees associated with the services were paid for or reimbursed by the company. See also PLR 200830009 (April 11, 2008).
- D.

V. EXAMPLES

A. Example 1 -- Costs that Facilitate an Issuance of Stock

- 1. Facts: Corporation X pays its outside counsel \$20,000 to assist X in registering its stock with the SEC. X is not a regulated investment company within the meaning of section 851.
- 2. X's payments to its outside counsel are amounts paid to facilitate the issuance of stock. As a result, X is required to capitalize its \$20,000 payment. Treas. Reg. § 1.263(a)-5(a)(8). See Treas. Reg. § 1.263(a)-5(l), Ex. 1.

B. Example 2 -- Costs that Facilitate a Borrowing

- 1. Facts: Corporation X seeks to purchase all of the outstanding stock of Corporation Y. In order to finance the acquisition, X must issue new debt. In preparation therefore, X pays an investment banker \$25,000 to market the debt to the public and pays its outside counsel \$10,000 to prepare the offering documents for the debt.
- 2. X's payment of \$35,000 facilitates a borrowing and must be capitalized. Treas. Reg. § 1.263(a)-5(a)(9). However, X's payment does not facilitate the acquisition of Y, even though X incurred the new debt to finance the acquisition. Treas. Reg. § 1.263(a)-5(c)(1). See Treas. Reg. § 1.263(a)-5(l), Ex. 2.

C. Example 3 -- Costs that Facilitate a Corporate Acquisition

- 1. Facts: On February 1, 2005, Corporation X begins investigating the acquisition of three potential targets: T corporation, U corporation, and V corporation. X's potential acquisition of T, U, and V represents three distinct transactions, any or all of which X might consummate. On March 1, 2005, X enters into an exclusivity agreement with T and stops pursuing U and V. On July 1, 2005, X acquires the stock of T in a tax-free

reorganization pursuant to section 368. X pays \$1,000,000 to an investment banker and \$50,000 to its outside counsel to conduct due diligence on the targets, to determine the value of T, U, and V, to negotiate and structure the transaction with T, to draft the merger agreement, to secure shareholder approval, to prepare SEC filings, and to obtain the necessary regulatory approvals.

2. Due Diligence Costs

- a. The amounts paid to conduct due diligence on T, U and V prior to March 1, 2005 (the date of the exclusivity agreement) are not amounts paid to facilitate the acquisition of the stock of T and are not required to be capitalized. Treas. Reg. § 1.263(a)-5(e)(1). Such amounts are therefore deductible to the extent they are ordinary and necessary business expenses within the meaning of section 162.
- b. However, the amounts paid to conduct due diligence on T on and after March 1, 2005, are amounts paid to facilitate the acquisition of the stock of T and must be capitalized. Treas. Reg. §§ 1.263(a)-5(a)(2).

3. Other Investigatory Costs

- a. The amounts paid to determine the value of T, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain necessary regulatory approvals must be capitalized because they are inherently facilitative amounts paid to facilitate the acquisition of the stock of T; this is true regardless of whether those activities occur prior to, on, or after March 1, 2005. Treas. Reg. § 1.263(a)-5(e)(2).
- b. The amounts paid to determine the value of U and V must be capitalized because they are inherently facilitative amounts paid to facilitate the acquisition of U or V. Because the acquisition of U, V, and T are not mutually exclusive transactions, the costs that facilitate the acquisition of U and V do not facilitate the acquisition of T. Accordingly, the amounts paid to determine the value of U and V may be recovered under § 165 in the taxable year that R abandons the planned mergers with U and V. Treas. Reg. § 1.263(a)-5(e)(2). See Treas. Reg. § 1.263(a)-5(l), Ex. 4.

D. Example 4 -- Employee Compensation

1. Facts: Assume the same facts as in Example 3, except that X pays a bonus of \$10,000 to one of its corporate officers who negotiated the acquisition of T.

2. X is not required to capitalize any portion of the bonus paid to the corporate officer. Treas. Reg. § 1.263(a)-5(d)(1). See Treas. Reg. § 1.263(a)-5(l), Ex. 5.

E. **Example 5 -- Integration Costs**

1. Facts: Assume the same facts as in Example 3, except that before and after the acquisition is consummated, R incurs costs to relocate personnel and equipment, provide severance benefits to terminated employees, integrate records and information systems, prepare new financial statements for the combined entity, and reduce redundancies in the combined business operations.
2. X is not required to capitalize any of these costs because they did not facilitate the acquisition of T. Treas. Reg. § 1.263(a)-5(c)(6). See Treas. Reg. § 1.263(a)-5(l), Ex. 6.

F. **Example 6 -- Compensation to Target's Employees**

1. Facts: Assume the same facts as in Example 3. Prior to the acquisition, certain employees of T held unexercised options issued pursuant to T's stock option plan, which granted the employees the right to purchase T stock at a fixed option price. The options were not included in the employees' income when granted. As a condition of the acquisition, T is required to terminate its incentive stock option plan. Accordingly, T agrees to pay its employees who hold unexercised stock options the difference between the option price and the current value of T's stock in consideration of their agreement to cancel their unexercised options.
2. T is not required to capitalize the amounts paid to its employees. Treas. Reg. § 1.263(a)-5(d)(1). See Treas. Reg. § 1.263(a)-5(l), Ex. 7.

G. **Example 7 -- Corporate Acquisition; Retainer**

1. Facts: Corporation Y's outside counsel charges Y \$60,000 for services rendered in facilitating corporation X's friendly acquisition of the stock of Y. Y has an agreement with its outside counsel under which Y pays an annual retainer of \$50,000. Y's outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y's outside counsel offsets \$50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of \$10,000.
2. The \$60,000 legal fee is an amount paid to facilitate the acquisition of an ownership interest in Y, and Y must capitalize the full amount of the \$60,000 legal fee. Treas. Reg. § 1.263(a)-5(a)(3). See Treas. Reg. § 1.263(a)-5(l), Ex. 9.

H. **Example 8 -- Corporate Acquisition; Antitrust Defense Costs**

1. **Facts:** On March 1, 2005, Corporation Y enters into an agreement with Corporation X to acquire all of the outstanding stock of X. On April 1, 2005, federal and state regulators file suit against Y to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. On May 1, 2005, Y enters into a consent agreement with regulators that allows the acquisition to proceed, but requires Y to hold separate the business operations of X pending the outcome of the antitrust suit. The agreement also subjects Y to possible divestiture based on the outcome of the antitrust suit. On June 1, 2005, Y acquires title to all of the outstanding stock of X. After June 1, 2005, the regulators pursue antitrust litigation against Y seeking rescission of the acquisition. Y pays \$50,000 to its outside counsel for services rendered after June 1, 2005, to defend against the antitrust litigation. Y ultimately prevails in the antitrust litigation.
2. Y must capitalize the costs incurred to defend the antitrust litigation because such costs facilitate Y's acquisition of the X stock. Treas. Reg. § 1.263(a)-5(a)(2). Even though title to the X shares passed to Y prior to the date Y incurred costs to defend the antitrust litigation, the acquisition was not complete until the antitrust litigation was ultimately resolved. Thus, the amounts paid by Y are paid in the process of pursuing the acquisition of the X stock. Y must capitalize the \$50,000 in legal fees. See Treas. Reg. § 1.263(a)-5(1), Ex. 10.

I. **Example 9 -- Corporate Acquisition; Hostile Defense Costs**

1. **Facts:** Corporation Y is a publicly traded corporation. On January 15, 2005, Y becomes the target of a hostile takeover attempt by Corporation Z. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential "white knight" acquirer. Y also pays amounts to complete a defensive recapitalization, and pays \$50,000 to an investment banker for a fairness opinion regarding Z's initial offer. Y's efforts to enjoin the takeover and to locate a white knight acquirer are unsuccessful. On March 15, 2005, Y's Board of Directors decides to abandon its defense against the takeover and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its anti-takeover measures, Y pays its investment bankers \$1,000,000 for a second fairness opinion and for services rendered in negotiating with Z.
2. **Treatment of Legal Fees**

Y is not required to capitalize the legal fees paid to seek an injunction against the takeover because they are not amounts paid in the process of investigating or otherwise pursuing the transaction with Z. Treas. Reg. §

1.263(a)-5(b)(1).

3. Treatment of White Knight Location Fees

Y is not required to capitalize the investment banking fees paid to search for a white knight acquirer because they do not facilitate an acquisition of Y by a white knight. Treas. Reg. § 1.263(a)-5(b)(1). None of Y's costs with respect to a white knight were inherently facilitative amounts and Y did not reach the date described by Treas. Reg. § 1.263(a)-5(e)(1) with respect to a white knight.

4. Treatment of Amounts Incurred to Recapitalize

The amounts paid by Y to investigate and complete the recapitalization must be capitalized because they are not amounts paid to defend against a hostile acquisition attempt, but are amounts incurred to facilitate a recapitalization. Treas. Reg. § 1.263(a)-5(a)(4).

5. Treatment of Investment Banker Fees

Y must capitalize the \$50,000 paid to the investment bankers for a fairness opinion during Y's defense against the takeover and the \$1,000,000 paid to the investment bankers after Y abandons its attempts to defend against the takeover because they are inherently facilitative amounts with respect to the transaction with Z. Treas. Reg. § 1.263(a)-5(a)(3). See Treas. Reg. § 1.263(a)-5(l), Ex. 11.

J. Example 10 -- Corporate Acquisition; Break Up Fees to White Knight

1. Facts: Assume the same facts as in Example 9, except that Y's investment banker finds W, a white knight. Y and W execute a letter of intent on March 10, 2005. Under the terms of the letter of intent, Y must pay W a \$10,000,000 break-up fee if the merger with W does not occur. On April 1, 2005, Z significantly increases the amount of its offer, and Y decides to accept Z's offer instead of merging with W. Y pays its investment banker \$500,000 for inherently facilitative costs with respect to the potential merger with W. Y also pays its investment banker \$2,000,000 for due diligence costs with respect to the potential merger with W, \$1,000,000 of which relates to services performed on or after March 10, 2005.

2. Treatment of Investment Banker Fees

Y's \$500,000 payment for inherently facilitative costs and Y's \$1,000,000 payment for due diligence activities performed on or after March 10, 2005 (the date the letter of intent with W is entered into) facilitate the potential merger with W. Because Y could not merge with both W and Z, the payments also facilitate the transaction between Y and Z. Accordingly, Y

must capitalize the \$500,000 and \$1,000,000 payments as amounts that facilitate the transaction with Z. Treas. Reg. § 1.263(a)-5(c)(8).

3. Treatment of Break Up Fees

Because Y could not merge with both W and Z, the \$10,000,000 termination payment facilitates the transaction between Y and Z.

Accordingly, Y must capitalize the \$10,000,000 termination payment as an amount that facilitates the transaction with Z. Treas. Reg. § 1.263(a)-5(c)(8). See Treas. Reg. § 1.263(a)-5(l), Ex. 13.

K. Example 11 -- Corporate Acquisition; Break Up Fees

1. Facts: Corporation X and Corporation Y enter into an agreement under which Y would acquire all the stock or all the assets of X in exchange for Y stock. Under the terms of the agreement, if either party terminates the agreement, the terminating party must pay the other party \$10,000,000. Y decides to terminate the agreement and pays X \$10,000,000. Shortly thereafter, Y acquires all the stock of Corporation Z, a competitor of X. Y had the financial resources to have acquired both X and Z.
2. Y is not required to capitalize the \$10,000,000 payment because U's \$10,000,000 payment does not facilitate Y's acquisition of Z. Treas. Reg. § 1.263(a)-5(c)(8). See Treas. Reg. § 1.263(a)-5(l), Ex. 14.

Exhibit 1 -- Common Law

| <u>COSTS</u> | <u>ARE COSTS GENERALLY DEDUCTIBLE?</u> | <u>AUTHORITIES</u> |
|--|---|--|
| <u>Friendly Acquisition Costs</u> | | |
| Target's Costs | No (unless investigatory and incurred prior to a final decision) | <u>INDOPCO</u> ; <u>Wells Fargo</u> ; Rev. Rul. 99-23 |
| Acquiring Corporation's Costs | No (unless investigatory and incurred prior to a final decision) | <u>Hilton</u> ; <u>Ellis Banking</u> ; <u>American Stores Co.</u> ; <u>Wells Fargo</u> ; Rev. Rul. 99-23 |
| Shareholders' Costs | No | <u>Woodward</u> ; Rul. 67-411; <u>But see Picker</u> |
| Payments by Target to Employees for Stock Options | Yes (as compensation) | Rul. 73-146. <u>But see Walter Corp.</u> |
| Severance Payments to Employees | Yes | Rul. 67-408; TAM 9326001 |
| <u>Hostile Acquisition Costs</u> | | |
| Defending Against Hostile Acquisitions | Yes (unless costs result in long-term benefit) | TAM 9043003; TAM 9144042. <u>But see FSA 200103004.</u> |
| Break-up Fees to White Knights | Authorities Conflict. Service: No; Bankruptcy Court & S.D. Ohio: Yes | TAM 9043003; <u>In re Federated</u> |
| Greenmail | No | § 162(k); TAM 9144042 |
| Unsuccessful Defenses Against Hostile Acquisitions | Authorities conflict | <u>In re Federated</u> ; <u>Victory Markets</u> ; <u>A.E. Staley</u> |
| Costs of Financing in Order to Redeem Shares | Yes, over the term of the loan. Older authorities conflict: Tax Court: No; 9th Circuit: Yes | New § 162(k); <u>Fort Howard</u> ; <u>In re Kroy</u> |
| Abandoned Transactions | Yes (as a § 165 loss) | <u>Doernbecher</u> ; Rul. 73-580 |
| Divisive Reorganizations | Not settled. (Yes, if required to divest by statute or court) | <u>E.I. DuPont</u> ; <u>General Bancshares</u> ; <u>Transamerica</u> |
| Proxy Fights | Yes | <u>Locke</u> ; <u>Central Foundry</u> ; Rul. 67-1 |