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New Regulations Regarding Treatment of Transaction Costs

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The tax treatment of transaction costs incurred to facilitate either (i) the creation, acquisition, or enhancement of an intangible asset or (ii) a restructuring or reorganization of a business entity or a capital-raising transaction has been the subject of controversy for many years.

Taxpayers have generally sought, to the greatest extent possible, to deduct such expenditures on a current basis. Conversely, the IRS has taken the view that such expenditures are required to be capitalized, with the result that the tax benefit of incurring the cost is realized either through depreciation or amortization or on a lump-sum basis at a later date, in connection with the disposition of an identifiable tangible or intangible asset to which the cost related or upon the liquidation of the entity that incurred the cost.

Focus on this issue was sharpened by the Supreme Court's decision in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). In that case, involving a friendly acquisition of one publicly traded corporation by another, the government successfully argued that investment banking and legal fees and other expenses incurred by the *acquired* corporation in connection with its own acquisition had to be capitalized, because the acquisition was expected to result in long-term benefits to the acquired corporation.[1]

The question of at what point in time, following the acquisition, the acquired corporation could deduct its costs was not at issue in INDOPCO. However, as the expenditures did not relate to the creation of a specific asset with an ascertainable useful life, it appears that the costs could not be deducted until the dissolution of the corporation.

After INDOPCO, the IRS appeared to become more aggressive in seeking the capitalization of a variety of transaction expenses, with mixed results in the Tax Court and the Courts of Appeals.[2] The breadth of some of the IRS assertions regarding the extent of costs required to be capitalized has been controversial. In order to provide greater certainty in this area, the Internal Revenue Service recently proposed extensive regulations (REG-125638-01) regarding the capitalization and deduction of expenditures incurred to acquire, create, or enhance intangible assets.

The proposed regulations deal with a variety of intangible asset costs, including: expenditures to create financial interests; prepaid expenses; payments to obtain, modify, or terminate certain contract rights; and certain payments relating to real property. The focus of this article, however, is limited to the part of the proposed regulations (Prop. Reg. section 1.263(a)-4(e)) concerning transaction costs.

The proposed regulations, although consistent with the result reached in INDOPCO, appear to represent a retreat by the IRS from some of the more aggressive positions it has taken since INDOPCO as to the types of transactions where capitalization is required and as to the expenses that must be capitalized in those transactions.

The Proposed Regulations

Under the proposed regime, the basic rule would be that a taxpayer must capitalize any amount paid to facilitate (i) the acquisition, creation, or enhancement of an intangible asset, or (ii) a restructuring or reorganization of an entity or a capital-raising transacttion, such as the issuance of stock, a borrowing, or a recapitalization.

An amount is treated as paid to facilitate a transaction if the amount is paid "in the process of pursuing the transaction." The fact that an amount would not have been paid "but for" the transaction will not necessarily cause the amount to be treated as having been paid to facilitate the transaction.

For example, the preamble to the proposed regulations ("Preamble") notes that costs to reduce workforce after a corporate merger, or to integrate the operations of businesses that are being combined, are not required to be capitalized under this rule because they do not facilitate the merger itself.

Acquisition of a Business.

With respect to transactions involving the acquisition of a trade or busi-

ness, either through an acquisition of assets or of stock, two tests are set forth to determine whether a cost will be treated as facilitating the transaction and will therefore be required to be capitalized.

First, an amount paid (by the acquirer or the target) in the process of pursuing an acquisition facilitates the transaction if it relates to activities performed after the earlier of (i) the date the acquirer delivers to the target a letter of intent, offer letter, or similar communication proposing a merger or acquisition; or (ii) the date an acquisition proposal is approved by the taxpayer's board of directors.

Second, an amount is treated as facilitative, even if paid for a service performed before the date indicated by the rule described immediately above, if paid for an activity that is "inherently facilitative". Inherently facilitative expenditures are described in the proposed regulations as consisting of amounts paid for activities performed: to determine the value of the target; to structure or negotiate the transaction; to prepare or review transactional documents; to obtain regulatory approval; to secure tax advice or a fairness opinion; to obtain shareholder approval; or to convey property between parties to the transaction.

The two categories of costs summarized above are sufficiently broad, and the exceptions to capitalization set out in the Preamble are so limited, as to leave doubt as to whether any significant costs incurred prior to and in connection with an acquisition are not required to be capitalized.

A prior ruling of the IRS indicated that "investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or enter that business" need not be capitalized under IRC section 263 (Rev. Rul. 99-23, quoting from legislative history for IRC section 195). The Preamble states that the proposed regulations do not incorporate this standard, and instead adopts what is referred to as a "bright line" rule (consisting of the two tests summarized above), in the hope of minimizing controversies that have arisen regarding the interpretation of the standard in Rev. Rul. 99-23.

The discussion in the Preamble and the proposed regulations seems consistent with the concept that certain preliminary investigatory costs, for example, will remain not subject to capitalization.

Simplifying Conventions

Certain "simplifying conventions" limit the costs required to be capitalized under these rules. Compensation paid to employees, overhead, and "de minimis" costs (as defined below) are treated as amounts that do not facilitate a transaction.

The exclusion of compensation paid to employees applies to an employee bonus relating to an acquisition as well as to ordinary periodic compensation. The IRS thus appears to have retreated from the position previously taken by the government in litigation to the effect that compensation paid to corporate executives involved in an acquisition may be required to be capitalized.

Under the de minimis rule, amounts paid to facilitate a transaction, other than the acquisition, creation, or origination of financial interests (such as shares of stock or a debt instrument), are generally not required to be capitalized if the aggregate of such amounts does not exceed $5,000. If the amounts exceed $5,000, no portion of such amounts is excluded from capitalization under this rule.

Success-Based Fees

An amount the payment of which is contingent on the completion of an acquisition (and which is not covered by the exclusion above relating to employee compensation) is treated as facilitating an acquisition, except to the extent "evidence clearly demonstrates" that some portion of the amount relates to activities that did not facilitate the acquisition.

Divisive Transactions

The proposed regulations also include special rules concerning divisive transactions, such as the distribution of stock of a subsidiary. Amounts paid to facilitate a distribution of stock are not required to be capitalized if the divestiture is required by law, regulatory mandate, or court order, unless the divestiture itself facilitates another transaction for which costs are otherwise required to be capitalized under these rules.

If a taxpayer disposes of a business through a spinoff in order to secure regulatory approval for the acquisition of another corporation, the amounts paid to facilitate the divestiture are considered paid to facilitate the acquisition and must be capitalized.

Amounts paid to facilitate the sale of assets are not required to be capitalized under these rules unless (i) the sale is required by law, regulatory mandate, or court order and (ii) the sale itself facilitates another transaction with respect to which costs must be capitalized under this section.

Hostile v. Friendly Transactions

Special rules apply with respect to amounts paid to oppose a hostile acquisition. The general rule is that amounts paid by a target to defend against a hostile acquisition attempt are not required to be capitalized.

Whether an acquisition attempt is "hostile" is determined by reference to all the facts and circumstances. The mere fact that the offer is unsolicited does not establish that the acquisition attempt is hostile; however, implementation of defensive measures by the taxpayer may be cited as evidence that an acquisition attempt is hostile.

Once an acquisition attempt ceases to be hostile, further amounts spent by the target in furtherance of the acquisition of its stock by the acquirer are considered to be amounts paid to facilitate the transaction and therefore are subject to capitalization.

Amounts paid to deter an acquisition through another transaction which is itself subject to these rules – e.g., amounts paid to effect a recapitalization to deter a hostile acquisition attempt – are not excluded from capitalization under the hostile acquisition rule summarized above.

Termination Fees

A payment made to terminate, or to facilitate the termination of, an existing

agreement (e.g., a break-up fee) constitutes an amount paid to facilitate a transaction, and therefore is subject to capitalization under this rule, if the completion of the transaction is expressly conditioned on the termination of the existing agreement.

Thus, if Corporation A agrees to be sold to Corporation B and to pay a break-up fee if the sale fails to occur, and A then enters into an agreement to be sold to Corporation C contingent on the termination of the agreement between A and B, an example in the proposed regulations indicates that the amount paid to terminate the A-B agreement will be treated as incurred to facilitate the A-C transaction.

By contrast, another example describes a situation in which Corporation X launches a hostile tender offer to acquire the stock of Corporation T; T then enters into an agreement with Corporation Y whereby Y agrees to offer a higher price to shareholders of T for their stock, with a break-up fee to be paid to Y if that transaction fails to close; and X then increases its offering price, ultimately resulting in the acquisition of T by X. If T pays the break-up fee to Y, that fee is not viewed as facilitating the acquisition by X because the acquisition was not expressly conditioned on the termination of the T-Y agreement.

Treatment of Capitalized Costs

The proposed regulations do not generally address whether and how transaction costs are to be amortized. Generally, transaction costs relating to the acquisition of stock or assets must be capitalized as part of the bases of the stock or assets acquired.

The Preamble notes that the safe harbor amortization rules provided elsewhere in the proposed regulations are not proposed to be applied to transaction costs such as those incurred in connection with a reorganization or other restructuring, but requests comment as to whether certain transaction costs should be amortizable under a safe harbor.

Observations

The Preamble invites comments on many questions set forth therein. Given this invitation and the general interest of tax practitioners and their clients regarding the resolution of issues dealt with in the proposed regulations, it seems likely that the Treasury will receive extensive comments, and significant changes may well be made to the regulations before they are finalized.

It should also be noted that the regulations are proposed to apply to amounts paid or incurred on or after the date final regulations are published, and therefore cannot be relied upon at this time.

Notwithstanding the above, taxpayers would be well advised to begin considering now whether their current practices with respect to the capitalization and deduction of transaction-related expenditures are consistent with what the proposed regulations would require if finalized, whether changes in recordkeeping will be necessary to permit accurate determination of the expenses incurred in connection with a transaction that are required to be capitalized, and whether incurring certain transaction-related costs at an earlier or later time within the acquisition process may affect whether certain costs are required to be capitalized.

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[1] It has always been clear that costs incurred by the acquiring corporation constitute capital expenditures with respect to the acquisition of the stock of the acquired corporation that cannot be deducted currently. The issue in INDOPCO related to the treatment of costs incurred by the acquired corporation, which did not acquire any identifiable asset in the transaction.

[2] *E.g.*, Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000), reversing 112 T.C. 89 (1999); PNC Bancorp, Inc. v. Commissioner, 212 F.3d 822 (3d Cir. 2000), reversing 110 T.C. 349 (1998); and A.E. Staley Manufacturing Co. v. Commissioner, 119 F.3d 482 (7th Cir. 1997), reversing 105 T.C. 166 (1995).

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