INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Target =

Buyer =

Business =

Products =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

$a=

$b =

$c =

$d =

$e =

$f=

$g =

$h =

$i =

$j =

ISSUES:

1. Whether certain professional and administrative fees paid by Target in connection with Taxpayer's Year 1 acquisition of Target stock created or enhanced a separate and distinct intangible asset under §§ 1.263(a)-4(b)(1)(iii) and 1.263(a)-4(b)(3)(i) of the Income Tax Regulations?

2. Whether Taxpayer properly claimed a loss deduction on behalf of Target under section 165(a) of the Internal Revenue Code for these professional and administrative fees for Taxpayer's taxable year ending Date 3, the taxable year in which Taxpayer sold all of its Target stock to Buyer, an unrelated third party?

CONCLUSIONS:

1. The professional and administrative fees paid by Target in connection with Taxpayer's Year 1 acquisition of Target did not create or enhance a separate and distinct intangible asset under §§ 1.263(a)-4(b)(1)(iii) and 1.263(a)-4(b)(3)(i).

2. Taxpayer may not claim a loss deduction under section 165 on behalf of Target for the professional and administrative fees incurred by Target related to its stock acquisition by Taxpayer in the taxable year in which the Taxpayer sold all of Target stock to Buyer.

FACTS:

Taxpayer is engaged in Business. In Year 1, Taxpayer acquired the stock of Target, a manufacturer of Products, in a taxable reverse triangular merger. In announcing the acquisition of Target stock, Taxpayer and Target stated that the merger was intended to achieve cost synergies that would generate long term growth and increased efficiencies for both entities' shareholders, customers, and employees. Taxpayer paid approximately $a for Target's stock, plus assumed liabilities in the amount of $b for a basis of $c.

In connection with the sale of its stock to Taxpayer, Target paid a total of $d in professional fees and administrative expenses. These included payments to several law firms, investment firms, accounting firms, other professional firms, and the Securities and Exchange Commission. Target determined that $e of these fees and expenses were paid in the process of investigating or otherwise pursuing its acquisition by Taxpayer, and therefore, were required to be capitalized as costs of facilitating the acquisition of its trade or business under § 1.263(a)-5(a). Target also determined that $f of these fees were "success-based fees" under § 1.263(a)-5(f) and utilized the safe harbor under Revenue Procedure 2011-29, 2011-18 I.R.B. 746, to allocate those success-based fees between facilitative costs, which were required to be capitalized under section 263, and non-facilitative costs, which may be deducted as business expenses under section 162. Under this safe harbor, Target allocated $g of the success-based fees to non-facilitative costs and deducted these amounts as business expenses under section 162 on its Year 1 short-year Form 1120. In accordance with Rev. Proc. 2011-29, Target allocated the remaining success-based fees to facilitative fees and added those fees to the amounts that it had already determined must be treated as facilitative costs for a total of $h in facilitative costs incurred in its acquisition by Taxpayer.

Taxpayer indicates that, in accordance with section 263, Target capitalized the $h in facilitative fees as an intangible asset on its tax books. Taxpayer stated that "since this asset was not acquired as part of the transaction, but rather created by the transaction, neither Taxpayer nor Target recorded an intangible asset for the $h in facilitative fees pursuant to Statement of Financial Accounting Standards No. 141 (2001) for separate intangibles acquired in business combinations." In addition, neither Taxpayer nor Target has amortized these fees under any section of the Code or regulations.

During an earnings call on Date 1, Taxpayer's CEO stated that an evaluation of Taxpayer's Products business resulted in a meeting wherein Taxpayer's Board of Directors authorized Taxpayer's executives to advance a plan to divest Taxpayer from its Products business. Afterward, Taxpayer engaged in a sale process involving many potential buyers, and eventually selected Buyer, which Taxpayer's CEO stated would better position the Products business to achieve its full potential.

On Date 2, Taxpayer entered into a stock purchase agreement with Buyer to sell Target to Buyer for $i. On Date 3, Taxpayer completed the sale of Target to Buyer pursuant to the agreement, resulting in an estimated capital loss of $j. On its consolidated corporate tax return for its taxable year ending on Date 4, when calculating the separate taxable income of Target under § 1.1502-12, Taxpayer claimed a section 165(a) loss deduction for Target of $h and reduced Target's separate taxable income by $h, representing the value of the administrative and professional fees capitalized under section 263(a). Taxpayer then included Target's separate taxable income in Taxpayer's consolidated taxable income under § 1.1502-11(a)(1). Because Taxpayer's deduction under section 165(a) reduced Target's separate taxable income, Taxpayer reduced its basis in Target stock by a corresponding amount under the investment adjustment rules of § 1.1502-32. The investment adjustment resulted in a lower basis in Target stock and, as a result, a reduced capital loss on the sale of Target.

LAW AND ANALYSIS:

Issue 1: Whether Target's professional and administrative fees create a separate and distinct intangible asset under §§ 1.263(a)-4(b)(1)(iii) and 1.263(a)-4(b)(3)(i).

Section 263(a) generally provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 1.263(a)-4(b)(1) provides that, in general, a taxpayer must capitalize: (i) an amount paid to acquire an intangible, (ii) an amount paid to create an intangible, (iii) an amount paid to create or enhance a separate and distinct intangible asset, (iv) an amount paid to create or enhance a future benefit identified in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalized is required under this section, or (v) an amount paid to facilitate the acquisition or creation of an intangible described in (i) through (iv) of this paragraph.

Section 1.263(a)-4(b)(3)(i) provides that the term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.

Section 1.263(a)-5 provides that a taxpayer must capitalize an amount paid to facilitate a business acquisition or reorganization transaction described in § 1.263(a)-5(a), which includes, among other transactions, 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). Section 1.263(a)-5(a)(3).

Section 1.263(a)-5(g) provides for the treatment of facilitative costs capitalized under § 1.263(a)-5(a). Although § 1.263(a)-5(g)(2) provides rules for the treatment of the acquirer and target corporations in taxable acquisitive transactions that involve asset acquisitions, § 1.263(a)-5(g) expressly reserves on the treatment of target's facilitative costs in a taxable stock acquisition.

The first issue posed by Compliance, Large Business and International (the Field) is whether certain professional and administrative fees paid by Target in connection with the taxable acquisition of its stock by Taxpayer create or enhance a separate and distinct intangible asset within the meaning of §§ 1.263(a)-4(b)(1)(iii) and 1.263(a)-4(b)(3)(i). Taxpayer clarified in its conference of right that it agreed with the Field that the professional and administrative fees incurred by Target in its acquisition by Taxpayer would not qualify as a separate and distinct intangible asset as expressly defined in § 1.263(a)-4(b)(3)(i). Thus, Taxpayer presented no arguments that the amounts paid by Target comprise a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged separate and apart from its trade or business. Instead, Taxpayer argues that Target paid these amounts to create a separate and distinct intangible asset in the form of the synergistic benefits that Target expected to receive from its combination with Taxpayer. Taxpayer contends that these benefits arose from Target's access to Taxpayer's markets, research, quality and innovation platforms, management approaches, and supply chain productivity tools. Under this analysis, Taxpayer argues that the administrative and professional fees paid by Target in connection with Taxpayer's acquisition of its stock created a separate and distinct intangible asset that was properly capitalized by Target, but this asset became useless to Target at the termination of its relationship with the taxpayer, that is, when Taxpayer sold Target's stock to Buyer.

Taxpayer contends that this conclusion is consistent the Supreme Court's analysis in INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 86-90 (1992), which reasoned that professional expenses incurred by a target corporation in the course of a friendly takeover were required to be capitalized under section 263, in part, because of the synergistic benefits expected to be generated by the combination of the target and acquirer's businesses. Taxpayer contends that in Target's case, these synergistic benefits comprised a separate asset that is properly recoverable at the end of the asset's useful life, consistent with the premise of INDOPCO. Taxpayer also argues that, by not providing regulations that specifically address the treatment of a target's capitalized facilitative costs in taxable stock acquisitions, the IRS has implicitly sanctioned alternative treatments, such as "treating such costs as creating a new asset the basis of which may or may not be amortizable." See Notice 2004-18, 2004-11 I.R.B. 605 (requesting comments on the tax treatment of capitalized facilitative costs).

The Field argues, and this office agrees, that the treatment of Target's professional and administrative costs is clearly addressed by the regulations under section 263 and the case law that underlies these regulations. As summarized previously in this memorandum, § 1.263(a)-4 provides the rules for determining whether a taxpayer must capitalize (i) amounts paid to acquire an intangible, (ii) amounts paid to create an intangible, or (iii) amounts paid to create or enhance a separate or distinct intangible asset as defined in § 1.263(a)-4(b)(3). In contrast, § 1.263(a)-5 provides the rules for determining whether a taxpayer must capitalize the amounts paid or incurred to facilitate the acquisition of a trade or business, a change in capital structure of a business entity and certain other transactions. Section 1.263(a)-5(a)(3) provides that a taxpayer must capitalize an amount paid to facilitate an acquisition of an ownership interest in the taxpayer.

Both the Field and Taxpayer agreed in their submissions that Target's professional and administrative fees were incurred by Target in the acquisition of its business by Taxpayer and that these fees facilitated this acquisition under § 1.263(a)-5(b). Moreover, Taxpayer provided no arguments that these costs were incurred to acquire or create any of the intangible assets described or defined in § 1.263(a)-4. As such, the professional and administrative fees paid by Target are not amounts incurred to acquire or create a separate and distinct intangible under § 1.263(a)-4 and are not capitalized under that section of the regulations. Rather, § 1.263(a)-5 would govern the application of section 263(a) to Target's costs, and under these provisions, these fees were properly capitalized by Target as the costs of facilitating an acquisition of Target's business in accordance with § 1.263(a)-5(a)(3).

While the regulations under § 1.263(a)-5 are clear that a Target must capitalize the costs of facilitating the acquisition of its trade or business under section 263(a), Taxpayer correctly observes that § 1.263(a)-5(g) specifically reserves, and therefore does not address, the treatment of Target's costs capitalized in a taxable stock acquisition. Taxpayer is also correct that the Treasury Department and the IRS have requested comments on the proper treatment of certain costs that facilitate certain tax-free and taxable transactions that are required to be capitalized under section 263 and § 1.263(a)-5. Nevertheless, the absence of regulations and the IRS's request for comments on the treatment of capitalized fees under a variety of circumstances do not imply that any particular treatment is correct. Rather, with regard to Taxpayer's facts, we believe that longstanding case law, including the Supreme Court's analysis in INDOPCO, is instructive and determinative.

In INDOPCO, the Supreme Court addressed a situation that was similar to the facts provided in this request for Technical Advice. In that case, the Court decided that certain professional investment, banking, and legal costs incurred by a target corporation in the course of a friendly takeover were required to be treated as capital expenditures under section 263. In its analysis, the Court clarified that the creation of separate and distinct asset may be sufficient, but was not a necessary prerequisite for determining that a taxpayer must capitalize costs under section 263. INDOPCO, 503 U.S. at 86. Second, the Court determined that a taxpayer's expectation of significant future benefits from a corporate acquisition or restructuring is another appropriate basis to require capitalization under section 263. Id. at 87. The Court noted that the target expected to benefit from both the acquiring corporation's enormous resources and from the cost savings and administrative conveniences stemming from its transformation from a freestanding corporation to a wholly owned subsidiary. Id. at 88-89. The Court stated that the courts have long held these expenses to be "incurred for the purpose of changing the corporate structure for the benefit of future operations…." Id. at 89 (quoting General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (quoting Farmers Union Corp. v. Commissioner, 300 F.2d 197, 200 (9th Cir. 1962), cert. denied, 371 U.S. 861 (1962)); Mills Estate v. Commissioner, 206 F.2d 244, 246 (2d Cir. 1953). The Court also pointed out that courts more frequently have characterized an expenditure as capital in nature because the "purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year." INDOPCO, 503 U.S. at 90 (quoting General Bancshares, 326 F.2d at 715). See also Motion Picture Capital Corp. v. Commissioner, 80 F.2d 873 (2d Cir. 1936) (holding that taxpayer was required to capitalize legal fees and expenses incurred to facilitate its merger).

Thus, in INDOPCO, the Court addressed not only the requirement to capitalize costs that produce significant future benefits, but also the nature of professional and administrative costs incurred by a target corporation in the course of its acquisition by another corporation. In its reasoning, the Court made clear that these costs were incurred for the restructuring of the target corporation, its continuing operations and betterment, for the duration of its existence, and not for the acquisition of an intangible asset that was separate and distinct from its ongoing business. See INDOPCO, 503 U.S. at 90. In discussing the treatment of capital expenditures, the Court explained that a capital expenditure is usually amortized or depreciated over the life of the relevant asset or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. Id. at 83-84. We believe that Taxpayer's facts are analogous to the facts in INDOPCO and that the same analysis and conclusion are warranted. Thus, the professional and administrative fees paid by Target in connection with Target's acquisition by the Taxpayer did not create or enhance a separate and distinct intangible asset under section 263(a) and the regulations thereunder but were incurred to facilitate a restructuring of Target's trade or business under sections 263(a) and 1.263(a)-5. Consistent with INDOPCO, these facilitative costs are characterized as the costs of acquiring significant future benefits for Target's business and operations, and they would remain capitalized for the life of that business, generally, the duration of the Target's business enterprise.

Issue 2: Whether Target may claim a loss deduction under section 165 for its capitalized professional and administrative fees.

Section 165(a) of the Code provides there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(b) provides that the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

Section 1.165-1(b) of the regulations generally provides that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year.

Section 1.165-2(a) generally provides that a loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in which business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. Section 1.165-2(b) provides in part that a deduction under § 1.165-2(a) is not allowed for losses sustained upon the sale or exchange of property.

The second issue posed by the Field is whether Taxpayer properly claimed a loss deduction on behalf of Target under section 165(a) for Target's capitalized professional and administrative fees on Taxpayer's consolidated tax return for the taxable year in which Taxpayer sold Target's stock to Buyer. Taxpayer argues that Target's previously capitalized fees are deductible as a loss to Target under section 165 because the asset created by the capitalization of these fees, that is, the synergistic benefits, became worthless to Target when Taxpayer sold Target's stock. Taxpayer contends that its divestiture of Target's business comprised the identifiable event that closed the transaction and fixed Target's loss. Taxpayer relies on Echols v. Commissioner, 935 F.2d 703 (5th Cir. 1991), motion for reh'g denied, 950 F.2d 209 (5th Cir. 1991), which supported the use of the worthlessness test as an alternative to a finding of abandonment, to support a loss under section 165. In Echols, the court concluded that the petitioners could properly claim a loss under section 165 for their partnership interest based on their showing of an overt abandonment of the interest, or alternatively, based upon their showing that the partnership interest was subjectively worthless at the time of an objectively identifiable event. Id. at 706-07. Using this approach, Taxpayer contends Target's subjective determination that its asset was worthless was evidenced by Taxpayer's announcement that it planned to divest Target's business, and the identifiable event occurred, and the loss was sustained, when the Taxpayer sold Target's stock to Buyer.

We disagree with Taxpayer's analysis that Target sustained a loss upon which it could claim a deduction under section 165. First, as discussed above, the professional and administrative fees paid by Target in connection with Target's acquisition by the Taxpayer did not create or enhance an intangible asset separate and apart from Target's business, but rather were incurred to benefit Target's trade or business. If the purpose of the expenditure has to do with the enhancement of a corporation's operations, then the useful life of the expenditures would be measured by the duration of those operations. See INDOPCO, 503 U.S. at 83-84. Under these circumstances, a taxpayer would generally not be permitted to recover these costs until the dissolution of the business enterprise or until the occurrence of another event that ends the useful life of the business. See id. In the current case, Taxpayer has not shown that Target abandoned its business or that Target's business operations were dissolved.

In addition, Taxpayer has not provided any evidence that Target either subjectively determined or objectively manifested that its business was worthless. Taxpayer's announcement of its decision to divest may have reflected Taxpayer's financial difficulties but did not demonstrate Target's determination that its business was worthless. Assets may not be considered worthless, even when they have no liquidated value, if there is a reasonable hope and expectation that they will become valuable in the future. See Lawson v. Commissioner, 42 B.T.A. 1103, 1108 (1940); Morton v. Commissioner, 38 B.T.A. 1270, 1278 (1938), aff'd, 112 F.2d 320 (7th Cir. 1940); Rev. Rul. 77-17, 1977-1 C.B. 44. Further, Taxpayer's sale of Target's stock to Buyer may have been a taxable event to Taxpayer but did not represent a closed or completed transaction upon which Target could claim a loss under section 165. In fact, after the sale, Target continued to exist as a corporation and continued to operate its Products business under Buyer. A deduction is not allowable under section 165 if a taxpayer intends to hold and preserve property for possible future use or to realize potential future value from the property. Rev. Rul. 2004-58, 2004-24 I.R.B 1043 (citing A.J. Indus. Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974)).

Thus, neither Taxpayer's decision to divest itself of Target's business nor its sale of Target's stock were sufficient to demonstrate evidence of worthlessness or a closed and completed transaction with respect to Target's business. Accordingly, Target was not entitled to a loss under section 165 for the taxable year in which its stock was sold by Taxpayer.

Because the section 165(a) loss is disallowed, Taxpayer must recompute several items reported on its consolidated return for its taxable year ending Date 3. First, Target's separate taxable income must be increased by $h. Second, Taxpayer's consolidated income must be increased by a corresponding amount. Third, Taxpayer must increase its basis in Target by $h. This increase in Taxpayer's basis in Target stock will result in an increased capital loss from the sale of Target.

CONCLUSIONS:

1. The professional and administrative fees paid by Target in connection with Taxpayer's Year 1 acquisition of Target did not create or enhance a separate and distinct intangible asset under §§ 1.263(a)-4(b)(1)(iii) and 1.263(a)-4(b)(3)(i).

2. Taxpayer may not claim a loss deduction under section 165 on behalf of Target for the professional and administrative fees incurred by Target related to its stock acquisition by Taxpayer in the taxable year in which the Taxpayer sold all of Target stock to Buyer.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Except as expressly provided herein, no opinion is expressed or implied concerning the federal income tax consequences of any aspect of any transaction or item discussed or referenced in this ruling.