Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMC:DEN:TL-N-2298-00
AMHarbutte

date: AUG 15 2000

to: Gene Bybee, Revenue Agent
LMSB, Salt Lake City Utah

from: Alice M. Harbutte, Attorney, Denver, Colorado

subject: [redacted] Pre-Filing Agreement
FYE [redacted]

This memorandum is in response to your request for advice on an issue concerning the application of I.R.C. § 195 to certain fees paid by [redacted] to [redacted] and whether they qualify as start-up expenses under I.R.C. § 195.

ISSUE

1. Whether fees paid by [redacted] to [redacted] under the terms of an engagement letter dated [redacted], qualify as start-up expenses under I.R.C. § 195, and thus, would be subject to amortization over a 60 month period.

CONCLUSION

1. No. The fees paid to [redacted] are capital in nature and may not be amortized under I.R.C. § 195 as start-up expense but must be capitalized under I.R.C. § 263.

FACTS

On [redacted], [redacted] and [redacted] entered into an Agreement and Plan of Merger pursuant to which [redacted] acquired all of the outstanding securities of [redacted] and [redacted] became a subsidiary of [redacted]. On [redacted], [redacted] publicly announced that it had agreed to buy [redacted] for $[redacted] in stock. Board of Directors minutes of [redacted], show that the Board of Directors authorized the management of [redacted] to proceed with the negotiation of a merger agreement with [redacted] on [redacted].

On [redacted], a Joint Proxy Statement and Prospectus was issued by both [redacted] and [redacted] to their shareholders so that they could evaluate the merger. The stockholders of both [redacted]'s and [redacted] approved the merger. The acquisition of [redacted] by [redacted] required FTC approval. The FTC required [redacted]'s to divest itself of certain assets. The merger was finally consummated on [redacted]. [redacted] takes the position that for purposes of I.R.C. § 195(c)(2)(B) the acquired trade or business began on [redacted], so that the amortization period for any I.R.C. § 195(c) expenses begins on this date even though these expenses were incurred prior to [redacted].

On [redacted], [redacted], requested to participate in the Service's Pre-filing Agreement Pilot program announced in Notice 2000-12. Their application to participate was accepted by the Service. Pursuant to Notice 2000-12, the purpose of the pre-filing program is for the taxpayer and the Service to agree on the tax treatment of certain items limited to those items set forth in Notice 2000-12. Specifically with respect to [redacted], the tax items under consideration are certain expenses relating to the acquisition by [redacted] of [redacted]. The tax return in question is for [redacted] fiscal year ended [redacted] and is due to be filed by [redacted]. Notice 2000-12 provides that a pre-filing agreement may cover: "The determination of which costs are investigatory costs incurred to determine whether to enter a new business and which business to enter for purposes of qualifying as start-up costs under § 195. See Rev. Rul. 99-23, 1999-20 I.R.B. 3."

One issue which has arisen in the pre-filing discussions concerns the proper characterization, as either capital or ordinary, of fees [redacted] paid to [redacted] in the amount of $[redacted] in connection with this acquisition.

By letter dated [redacted], [redacted] engaged [redacted]. The engagement letter specifically provides as follows:

> [redacted] is please to act as financial advisor to [redacted] (the"Company") in connection with a possible Acquisition Transaction involving a company we have code-named [redacted] (the "Acquisition Candidate")

In the engagement letter [redacted] agreed to pay [redacted] the following fees:

(1) A fee of (i) $[redacted] contingent upon and payable in cash upon the execution of a definitive agreement to effect an Acquisition Transaction with [redacted]; and

(2) If, during the period [redacted] is retained by the Company or within one year thereafter, (a) an Acquisition Transaction is consummated with [redacted] or (b) the Company or a Company Affiliate enters into an agreement with [redacted] which subsequently results in an Acquisition transaction, an additional fee of $[redacted], payable in cash upon the closing of such Acquisition Transaction. Any fees previously paid to [redacted] pursuant to clause (1) of this paragraph will be deducted from any fee to which [redacted] is entitled pursuant to this clause (2).

Since the merger took place, [redacted] was paid the $[redacted] required under paragraph (2) in the engagement letter that is set forth above. The taxpayer would like to treat these fees or a portion of these fees as being amortizable under I.R.C. § 195.

DISCUSSION

Two types of expenses are amortizable under I.R.C. § 195: 1) start-up expenses that are investigatory costs incurred prior to reaching a final decision to acquire or enter into that business; and 2) start-up expenses that are expenses incurred after the final decision to acquire a business but prior to the date the actual operations begin which expenses would otherwise be deductible if actual operations had begun.

Section 195 allows a taxpayer to amortize start-up expenses that are deductible in nature when incurred prior to the actual start of the business. The purpose in enacting I.R.C. § 195 was to create parity between expenses incurred by someone who was expanding an existing trade or business and thus met the active trade or business requirements of I.R.C. § 162 with a person incurring these same expenditures who was rot able to take a deduction under I.R.C. § 162 since the business had not yet commenced. See Duecaster v. Commissioner, T.C. Memo 1990-518 ("Nothing in the statute or the legislative history suggests that section 195 was intended to create a deduction, by way of amortization, in respect of an item which would not, in any event, have been deductible under prior law.")

When section 195 was enacted in 1980, Congress believed that pre-opening expenses were not deductible under either 162(a) or 212. In explaining the purpose of section 195, the Senate report summarized pre-existing law:

> Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity.

S. Rep. No. 96-1036, 96th Cong., 2d Sess. 10, reprinted in 1980 U.S. Code Cong. & Ad. News 7293, 7300.

Expenses that are capital in nature are not "deductible in nature" and are excluded from I.R.C. § 195 and may not be amortized over 60 months. Commissioner v. Lincoln Sav. & Loan Association, 403 U.S. 345, 353 (1971); I.R.C. § 263(a). With respect to capital expenditures it does not matter if the taxpayer is expanding an existing business or acquiring a new business, such expenditures must be amortized over the life of the relevant asset, or, if no specific asset or useful life can be ascertained, then deductible upon dissolution of the enterprise. INDOPCO v. Commissioner, 503 U.S. 79, 83-84 (1992).

Investigatory expenses are expenses incurred prior to the date the decision has been made by the company regarding which entity to acquire. Investigatory types of expenses relate to expense incurred in conducting the investigation of which company to acquire. Rev. Rul. 99-23. In addition, these expenses must be deductible in nature and not capital. I.R.C. § 195(c)(1)(B). Expenses incurred in the course of a general search for, or an investigation of, a business that relate to the decisions whether to purchase a business and which business to purchase are investigatory costs. However, once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital in nature. Rev. Rul 77-254, 1977-2 C.B. 63.

In Rev. Rul. 99-23, situation 3, on the date the acquirer (Y) instructed its law firm to prepare and submit a letter of intent to the target (Z) regarding the potential acquisition of the target, the Rev. Rul. concluded that the letter of intent indicated that Y had made its decision to acquire Z. Thus, expenses incurred relating to "due diligence" after this date had to be capitalized under I.R.C. § 263. They related to an attempt to acquire a specific target. Similarly, courts have long held that legal, brokerage, accounting, appraisal and similar costs **incurred to acquire** a capital asset are capital expenditures under I.R.C. § 263. Woodward v. Commissioner, 397 U.S. 572 (1970)(emphasis added).

More recently in Norwest v. Commissioner, 112 T.C. 89 (1999), the Tax Court held that expenses incurred prior to the date the board approved a specific acquisition were capital. The Tax Court did not focus on timing of the disputed costs but disallowed the claimed expenses even though incurred prior to the date the board formally approved the transaction. The Court held that the disputed expenses were mostly preparatory expenses that "enabled the bank to achieve the long-term benefit that it desired from the transaction" and the fact that the costs were incurred before the formal approval by management did not change the fact that all the costs were sufficiently related to the acquisiton transaction and thus, were capital. Norwest, 112 T.C. at 112; see also INDOPCO v. Commissioner, 503 U.S. 79 (1992).

The fees in question arose as a result of an engagement letter dated [redacted]. **[Ex. A]** These fees are neither investigatory in nature nor expenses incurred after the decision date but before the start-up date that are deductible in nature (i.e. I.R.C. § 162 expenses) All fees paid pursuant to the engagement letter are capital in nature for the following reasons.

First, the Board of Directors minutes for [redacted] indicate that the Board made up its mind to acquire [redacted] and authorized management to proceed with the negotiation of a merger on [redacted]. [redacted] was hired on [redacted]. Since the decision to acquire [redacted] was made prior to the date [redacted] was hired, the [redacted] fees cannot be investigatory in nature. The investigation had stopped and the decision had been made.

Second, the terms of the [redacted] engagement letter are very specific. [redacted] is not investigating various possible alternative targets for [redacted] to acquire but is focused on the [redacted] acquisition. [redacted] was hired to assist [redacted] in analyzing, structuring, negotiating and effecting a specific "Acquisition Transaction" with [redacted].

Third, [redacted]'s fee was wholly contingent upon the "Acquisition Transaction" between [redacted]'s and [redacted] going through. If the [redacted] and [redacted] reached an agreement to effect an acquisition [redacted] was to be paid a fee of $[redacted]. If an actual acquisition resulted, then [redacted] was to be paid a fee totaling $[redacted] deducting any prior payment of $[redacted] from this fee. Both fees were contingent upon some degree of this acquisition taking place. The fees were not being paid in order for [redacted] to provide information which would assist [redacted] management in making a decision as to which company to acquire. They already know which company they wanted to acquire: [redacted].

Last, these fees are not the type normally deductible under I.R.C. § 162 but are capital in nature. See, Norwest v. Commissioner, 112 T.C. 89 (1999); INDOPCO v. Commissioner, 503 U.S. 79 (1992). The Supreme Court in INDOPCO stated:

> Courts have long recognized that expenses such as these, "'incurred for the purposes of changing the corporate structure for the benefit of future corporations are not ordinary and necessary business expenses.'" INDOPCO, 503 U.S. at 89.

CONCLUSION

Since the fees were contingent upon the success of [redacted] attempt to acquire [redacted] and since [redacted] Board had already authorized management to commence negotiations with [redacted], it is clear that the fees paid to [redacted] were not investigatory fees under I.R.C. § 195(c)(1)(A)(i). Under INDOPCO, the fees are not ordinary and necessary business expenses. The $[redacted] fee paid to [redacted] is a capital expenditure under I.R.C. § 263 and not a start-up expense under I.R.C. § 195.

If you have any questions please call Attorney Alice M. Harbutte at (303) 844-258.

Alice M. Harbutte

ALICE M. HARBUTTE
Attorney