

Proposed Tax Regulations To Clarify Capitalization vs. Deduction Issue

One of the most important questions in income tax law is whether an expenditure can be deducted currently in determining the payor's tax liability, or whether it must be capitalized. Capitalization in some cases results in an asset that can be amortized or depreciated over time. In other cases, capitalization may afford only an offset to sale proceeds when the asset is disposed of or even preclude any type of deduction at any time. Over the years, this exercise in classification has given rise to enormous uncertainty and litigation and produced a wide body of confusing and contradictory authority.

Controversies of this nature burgeoned after the decision in *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79 (1992). In *INDOPCO*, the Supreme Court held that certain expenses related to a corporate restructuring were to be capitalized, placing great emphasis on the "significant future benefit" that the restructuring was found to entail. Because the court set no clear bounds for the application of this vague "significant future benefit" concept outside the dimensions of the specific transaction upon which it ruled, it was feared by many to call into question the treatment of many types of expenses that long had been routinely deducted. And indeed, revenue agents throughout the country have routinely invoked "significant future benefit" to assert that a host of everyday business activities give rise to capital expenditures.

The U.S. Treasury Department and the Internal Revenue Service recently issued proposed regulations (the "Regulations") providing rules for determining the extent to which certain costs must be capitalized for federal income tax purposes. If finalized as proposed, the Regulations would provide much needed clarification to this area of the tax law. The Regulations take a refreshingly practical approach to the capitalization vs. deduction issue (known among tax lawyers as the "INDOPCO" issue). With a view towards adopting clear, generally easy to apply rules, the Treasury Department and Internal Revenue Service have created a number of rules and presumptions that reduce uncertainty and the potential for conflict, and provide for surprisingly even-handed treatment of these expenses.

The Regulations are quite lengthy and cover a number of topics. This memorandum will briefly describe the provisions most directly relevant to mergers and acquisitions and related transactions. It will not focus on areas where the Regulations simply restate uncontroversial conclusions of existing law.

Compensation and Overhead Costs

The Regulations provide simplifying conventions for the treatment of employee and overhead costs incurred to facilitate (1) the acquisition, creation, or enhancement of certain intangible assets and (2) the restructuring or reorganization of a business entity or a transaction involving

the acquisition of capital (together, the “Covered Transactions”). The Regulations provide that compensation paid to employees, overhead, and certain *de minimis* costs relating to a Covered Transaction need not be capitalized. This new rule would apply regardless of the percentage of an employee’s time that is allocable to a Covered Transaction. Thus, for example, capitalization would not be required for compensation paid to an employee that is involved on a full time basis on merger transactions on behalf of an acquiring or target company. This is in marked contrast to positions taken by the IRS in prior rulings and controversies in which it sought to capitalize such costs. However, the IRS is considering permitting the use of these simplifying conventions only to taxpayers who deduct these cost for financial accounting purposes.

Amounts Paid to Create Contract Rights

In general, an amount paid to another party to create or terminate a contract right with the other party is not required to be capitalized as a separate and distinct asset (and, therefore, will generally be deductible), except as specifically required by the Regulations. Amounts paid to another party to create or originate contract rights with the other party would generally be required to be capitalized only if the amounts (1) create certain financial interests including equity interests in corporations, partnerships, or trusts and interests in certain financial instruments, such as debt instruments, notional principal contracts, and options or (2) are paid to the other party to induce that party to enter into, renew, or renegotiate a lease, a license, a contract providing the taxpayer the right to acquire or provide services, or a covenant not to compete.

Example 1—Amount Paid to Enter Into a Lease. V would like to enter into a lease of commercial property. V pays Q, the owner of the commercial property, \$50,000 as an inducement to enter into a 10-year lease with V. V must capitalize the \$50,000 payment because the payment is an amount paid to another party to induce that party to enter into an agreement providing V the right to use tangible property.

Example 2—Amount Paid to Enter Into a Supply Contract. V is a manufacturer and pays Q, a supplier, \$50,000

to induce Q to enter into a fixed, 10-year supply contract. V is not required to capitalize the payment and, consequently, V may be permitted to deduct the payment, because the Regulations do not specifically require a payment to induce a party to enter into a supply agreement to be capitalized as a separate asset.

Amounts Paid to Terminate Contract Rights

Amounts paid to another party to terminate an existing contract with the other party are generally required to be capitalized only if the amounts are paid to terminate (1) a lease of real or tangible personal property between the taxpayer (as lessor) and the other party (as lessee), (2) an agreement that grants the other party the exclusive right to acquire or use the taxpayer’s property or services or to conduct the taxpayer’s business, or (3) an agreement that prohibits the taxpayer from competing with the other party or from acquiring property or services from a competitor of the other party.

Example 3—Payment by Grantor to Terminate Option. W corporation owns one-half of the outstanding stock of X corporation. On July 1, 2002, W grants Y a 5-year call option that permits Y to purchase all of W’s stock in X. On June 30, 2004, W pays Y \$50,000 to terminate the option. W’s payment to terminate the option with Y constitutes a payment to terminate an exclusive right to acquire W’s property. Accordingly, W must capitalize its \$50,000 payment to Y.

Example 4—Break-up Fee; No Follow-on Transaction. W corporation enters into an agreement to merge with Y corporation. Prior to the merger, W decides that its business would be more successful if it does not merge with Y. W pays Y \$10,000,000 to terminate the merger agreement. At the time of the payment, W is not under an agreement to merge with any other entity. W is not required to capitalize its \$10,000,000 payment to Y because the Regulations do not specifically require a payment to terminate a merger agreement to be treated as a separate asset.

Acquisition-Related Transaction Costs

The Regulations clarify the treatment of many types of acquisition-related costs.

Investigatory Costs; Acquisition Costs

The Regulations provide a general, bright-line rule for distinguishing between costs of investigating a proposed acquisition (which are generally deductible) and costs that facilitate an acquisition of a trade or business (which are subject to capitalization). By doing so, the Regulations again replace existing law and standards that have caused much controversy between taxpayers and the IRS with more workable principles. The new rule would apply whether the acquisition is structured as an acquisition of stock or of assets and whether the taxpayer is the acquirer or the target. The new rule would require that an amount paid in the process of pursuing an acquisition of a trade or business be capitalized only (i) if the amount is “inherently facilitative” or (ii) if the amount relates to activities performed after the earlier of the date of a letter of intent (or similar communication) is issued or the date the taxpayer’s Board of Directors approves the acquisition proposal. Under this rule, amounts that do not facilitate the acquisition of a trade or business are generally deductible.

An amount paid to another person is “inherently facilitative” and, accordingly, must be capitalized regardless of when the cost is incurred, if it is paid for the following activities:

- determining the value of a target,
- negotiating or structuring the transaction,
- preparing and reviewing transactional documents,
- preparing and reviewing regulatory filings required by the target of the transaction,
- obtaining regulatory approval of the transaction,
- securing advice on the tax consequences of the transaction,
- securing an opinion as to the fairness of the transaction,
- obtaining shareholder approval of the transaction, or
- conveying property between the parties to the transaction.

Example 5—Corporate Investigation and Acquisition Costs. On February 1, 2002, R corporation decides to investigate the acquisition of three potential targets: T corporation, U corporation, and V corporation. On March 1, 2002, R signs a letter of intent with T and stops considering

U and V. On July 1, 2002, R acquires the stock of T in a tax free reorganization. R pays \$1,000,000 to an investment banker and \$50,000 to its outside counsel to conduct due diligence on all three targets, determine the value of T, U, and V, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain the necessary regulatory approvals.

Under the Regulations, the amounts paid to conduct due diligence on T, U, and V prior to March 1, 2002 are investigatory and, accordingly, are not amounts paid to facilitate the acquisition of the stock of T. Thus, those amounts are not required to be capitalized. However, amounts paid to conduct due diligence on T after March 1, 2002 must be capitalized because such costs were incurred after R signed a letter of intent.

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 are inherently facilitative amounts paid to facilitate the acquisition of T stock and must be capitalized whether or not those activities occurred prior to March 1, 2002.

The amounts paid to determine the value of U and V are inherently facilitative amounts paid to facilitate the acquisition of U and V and must be capitalized. However, these fees may be recovered in the taxable year that R abandons a possible acquisition of U and V.

Integration Costs

Amounts paid to integrate the business operations of the acquirer and the target do not constitute amounts paid to facilitate an acquisition, regardless of when the integration activities take place, and therefore may be deducted.

Example 6—Integration Costs. Same facts as Example 5. In addition, R incurs costs before and after the acquisition of T 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. All these costs are considered integration costs and, accordingly, R should be permitted to deduct these costs.

Break-Up Fee to Facilitate Another Acquisition

As illustrated by Example 4, an amount paid to terminate a merger or acquisition agreement is generally deductible. However, a taxpayer will be required to capitalize a break-up fee if the termination itself facilitates another Covered Transaction.

Example 7—Break-up Fee to Facilitate Acquisition. N corporation enters into an agreement with U corporation under which U agrees to purchase all of the outstanding stock of N for \$70 per share. The agreement between N and U provides that if the acquisition is not consummated, N will pay U \$1,000,000 as a break-up fee. N subsequently enters into an agreement with W pursuant to which W agrees to purchase all of N's outstanding stock for \$80 per share on the condition that N terminates its pending acquisition agreement with U. N terminates its agreement with U, pays U the \$1,000,000 break-up fee, and is acquired by W. N's payment of the break-up fee to U facilitates W's acquisition of N, which is another Covered Transaction, and, therefore, must be capitalized.

Cost Incurred To Defend Hostile Takeovers

In general, amounts paid to defend against a hostile takeover attempt are deductible, unless the amount facilitates another Covered Transaction. Also, once an acquisition attempt ceases to be hostile, an amount paid by a target to facilitate the acquisition of its stock must be capitalized.

Example 8: Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation on January 15, 2002. In an effort to defend against the takeover attempt, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential "white knight" acquirer, and also incurs costs to effect a recapitalization. Y's efforts to enjoin the takeover

and locate a white knight acquirer are unsuccessful, and on March 15, 2002, Y's Board of Directors decides to abandon its defense against the takeover attempt and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its defense against the takeover attempt, Y pays its investment bankers \$1,000,000 for a fairness opinion and for services rendered in negotiating with Z.

Under the Regulations, Y could deduct the legal fees it paid to seek an injunction and the investment banking fees it incurred to search for a white knight because such amounts were incurred in defense of a hostile takeover attempt. The amounts paid to effect the recapitalization, even though such amounts were incurred to defend against a hostile takeover, must be capitalized because the amounts facilitate another Covered Transaction (i.e., the recapitalization.). The \$1,000,000 paid to the investment bankers for the fairness opinion and other services after the takeover ceases to be hostile must be capitalized.

Conclusion

If adopted in their present form, the Regulations will bring much needed clarification to the tax treatment of many kinds of expenses commonly incurred in merger and acquisition transactions.

More Information

If you have questions, we would be pleased to provide additional details about the Regulations or advice about how the Regulations might affect your business or practice. For more information, please contact any of the attorneys listed below or any member of our Transactional Tax Practice group.

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