OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX & ACCOUNTING)
CC:IT&A

SUBJECT: I.R.C. § 263 – TAKEOVER DEFENSE EXPENSES

This Field Service Advice responds to your request dated June 7, 2000. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

Taxpayer =

Corporation A = .
Partnership B =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
$Amount =
$$Amount =

ISSUE:

Whether Taxpayer must capitalize under I.R.C. § 263 certain legal and investment banking fees it incurred as the target during a corporate takeover.

CONCLUSION:

Taxpayer must capitalize the fees it incurred during the takeover campaign.

FACTS:

Prior to Year 1, Taxpayer (formerly named Corporation A) was a publicly traded company engaged in the food-service business. Its business primarily involved the development and operation of

operations under various trade names. Taxpayer became the target of a takeover attempt in Year 1 when Partnership B began purchasing a significant number of Taxpayer shares of common stock on the open market and approached Taxpayer's management to attempt to achieve their cooperation in a takeover.

Taxpayer rejected Partnership B's acquisition proposal. Partnership B then commenced an unsolicited tender offer for Taxpayer's common stock. Taxpayer took a number of steps attempting to thwart the takeover, including the issuance of preferred stock purchase rights to its common stock holders, the filing of a lawsuit against Partnership B, the vigorous defense of several lawsuits filed against it by Partnership B, the postponement of the Year 1 annual meeting of stockholders during a proxy fight instigated by Partnership B, and the active evaluation of potential financial alternatives to the Partnership B tender offer. In fighting the takeover, Taxpayer paid fees of $Amount to certain investment advisors, banks, and lawyers. Moreover, there is evidence that the bulk of the fees paid were to evaluate the fairness of offers received or to be received–regardless of whether these offers were solicited, unwelcome, or otherwise.

The attempts to thwart Taxpayer's acquisition proved futile and in early Year 2, its Board of Directors announced that the company was for sale to the highest bidder. On the advice of their investment advisors, Taxpayer's Board recommended that the shareholders accept an increased offer from a corporation owned by Partnership B. Over the following several months, Partnership B's acquiring corporation lined up the permanent financing necessary to complete the transaction. In late Year 2, the acquisition was approved by the shareholders. A subsidiary of a corporation owned by Partnership B was the acquisition vehicle. It acquired 80% of Taxpayer stock and then merged into Taxpayer. On its federal corporate income tax returns for Years 1 and 2, Taxpayer deducted as ordinary and necessary business expenses the various amounts paid to investment bankers and law firms with regard to the above transactions.[1]

LAW AND ANALYSIS:

As related above, Taxpayer engaged others to render certain legal, financial, and investment advice concerning the proposed acquisition of its stock. As such, the facts of this case are similar to the situation in INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), with the purported distinction that the acquisition in the latter was a "friendly" one (from the beginning). Both targets hired investment banking firms to determine if the buyout price being offered was a fair price as well as to advise how to proceed strategically. Both companies incurred significant expense in that process. Both companies were ultimately acquired. The Court upheld our position in INDOPCO that all the expenses involved must be capitalized, while noting that long-term benefits were also inherent in the corporate restructuring.

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[1] As a consequence of the buyout, Taxpayer was ostensibly saddled with $$Amount in both public and private debt transferred to it by the acquiring corporation. Subsequently, as a result of the cost of servicing the debt assumed by Taxpayer and the limitations on its resources for funding its business needs, Taxpayer ultimately found that it could not survive under its resulting debt structure. In Year 3, it tried a recapitalization. In Year 4, Taxpayer was forced to file for bankruptcy protection under Chapter 11. Although it has since emerged from bankruptcy, in Year 5, it remains highly leveraged.

Taxpayer, for its part, argues that all of the countermeasures it took and the litigation that ensued manifests the hostile nature of the takeover and the fact that it was merely defending itself against interests that had no experience in its particular business and which could prove deleterious to that business. Additionally, it maintains that there was absolutely no future benefit to it as a result of the merger in light of the amount of debt it would be forced to take on and which, in fact, was ultimately reflected in the bankruptcy filing. These factual assertions may be true; nevertheless, it is our view that these do not constitute supporting grounds for allowing current deduction treatment.

While apparently conceding that so-called "friendly" merger costs of a target corporation may require capitalization treatment,[2] Taxpayer argues that "hostile" defenses nonetheless may be deducted, citing Federated Department Stores, Inc. v. United States, 94-2 U.S.T.C. ¶ 50,430 (S.D. Ohio 1994) (the court upheld the decision of the bankruptcy court that the costs incurred in the target's failed defense of a takeover were deductible) and relying chiefly upon A.E. Staley Manufacturing Co. v. Commissioner, 119 F.3d 482 (7th Cir. 1997), rev'g 105 T.C. 166 (1996).

In Staley, the Seventh Circuit held that the target's investment banker fees in a takeover battle were deductible. As Taxpayer notes, the appellate court stated that INDOPCO did not change the law with respect to costs incurred to defend a business. 119 F.3d at 489. The court found that the bulk of the fees were paid to "frustrate" the occurrence of the merger. Id. at 490. The Seventh Circuit focused on the law applicable to defending a business. It stated that proxy expenses, for example, to defend corporate policy are conceded deductible. See Locke Manufacturing Cos. v. United States, 237 F. Supp. 80 (D. Conn. 1964); Rev. Rul. 67-1, 1967-1 C.B. 28. After analyzing the various expenses incurred, it held that the majority were incurred to defend against takeover and were thus deductible. Only those expenses directly facilitating the eventual merger were to be capitalized.[3]

The aforementioned arguments ignore the tenet that expenses incurred in connection with the creation and adoption of a shareholder rights plan or other corporate capital structure should be capitalized. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79, at fn. 7 (1992), and the "changes in corporate

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[2] That is, presumably, with the qualification that long-term benefits are actually reaped.

[3] The Circuit Court also rejected the notion suggested by the Tax Court that the costs were not incurred in the corporation's trade or business and were instead a nondeductible dividend for the benefit of the shareholders of the target.

structure" cases cited there. In brief, it is of no consequence that the measures were adopted for the immediate purpose of defending against hostile merger overtures.

With respect to the argument that the heavy "debt-saddling" negated any putative long-term benefits of the acquisition--while having some initial practical appeal–the contention should also be rejected. As the Tax Court has noted:

> [W]e find petitioner's debt/equity argument less persuasive . . . because, in the context of leveraged buyouts, these transactions typically rely on large amounts of debt and increase debt/equity ratios in the acquired or newly formed companies well beyond conventional norms. Accepting petitioner's argument conceptually would require us to conclude that whenever an acquisition results in an increase in the target's debt to equity ratio a finding that no long-term benefit was obtained must follow. We cannot accept such a sweeping generalization as a universal truth.

<u>Victory Markets, Inc. v. Commissioner</u>, 99 T.C. 648, 663 (1992).

On the basis of the foregoing analysis, it is our position that capitalization treatment should be required for the fees in issue.

<u>CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:</u>

[redacted]

[redacted]

HEATHER C. MALOY

By: ______________________________
THOMAS D. MOFFITT
Acting Chief, Branch 1
Income Tax & Accounting Division