INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 11, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Number: 200521032
Release Date: 5/27/2005

Index (UIL) No.: 263.00-00
CASE-MIS No.: TAM-159330-04/CC:ITA:B02

Territory Manager

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer	=
X	=
Y	=
Z	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
a	=
b	=
c	=
d	=
e	=
f	=

ISSUE(S):

Whether the costs of terminating a merger paid by Taxpayer are deductible, either as ordinary and necessary business expenses under § 162 of the Internal Revenue Code or as an abandonment loss under § 165, or whether the costs must be capitalized under § 263.

CONCLUSION(S):

The termination expenses are nondeductible capital expenditures that must be capitalized under § 263.

FACTS:

Taxpayer is a corporation in the production industry. Three years prior to the taxable year at issue, X, another corporation in the production industry, began acquiring Taxpayer stock. X subsequently contacted Taxpayer about a potential combination of the corporations, but Taxpayer declined to pursue the merger possibility because of antitrust and political concerns.

In the year before the taxable year at issue, a syndicate of investors expressed an interest in a leveraged buy-out (LBO) of Taxpayer. Taxpayer's managers were receptive to the LBO because of the depressed value of Taxpayer's stock; they also recognized that Taxpayer had little in the way of takeover defenses and that an acquisition of Taxpayer at a large premium was possible.

The investors formed Y to acquire Taxpayer, and negotiations between the parties ensued. On Date 1, Y and Taxpayer entered into a merger agreement (Y Merger Agreement) whereby Y would purchase all of Taxpayer's stock at a dollars per share, followed by a merger of Y into Taxpayer, with Taxpayer as the surviving corporation.

The Y Merger Agreement provided that, under certain circumstances, Taxpayer would be permitted to terminate the agreement, and in some cases Taxpayer would be required to pay Y a termination fee of b dollars and to reimburse, up to c dollars, Y's out-of-pocket fees and expenses incurred in connection with the merger (Termination Expenses). The Y Merger Agreement provided that Taxpayer could terminate the agreement if:

If the merger with Y had been consummated, Taxpayer would have become a privately held corporation operating under the direction of Taxpayer's senior management. The acquisition by Y was seen as an attempt to keep Taxpayer from falling into the hands of outsiders.

On Date 2, X made an unsolicited offer to acquire all of the outstanding shares of Taxpayer stock through a tax-free merger. X proposed to exchange d dollars worth of X common stock for each outstanding share of Taxpayer stock.

Because Taxpayer's management did not wish for X to acquire Taxpayer, contact was made with Z to encourage Z to bid on Taxpayer. On Date 3, Z announced an offer to acquire all outstanding common stock of Taxpayer through a part cash, part stock transaction. In a letter from Z to Taxpayer, Z indicated the following reasons (among others) favoring the proposed transaction:

- The proposal avoids significant regulatory risk and attendant uncertainties (unlike a merger with X).
- The resulting company would be the world's leading supplier of products in that industry.
- Taxpayer and Z offer complementary products, operations, and philosophies.

The letter also indicated that the companies would combine only in ways that create strength, and that they do not anticipate any significant reduction in employment levels.

Subsequently X and Z actively engaged in bidding to acquire Taxpayer. On Date 4, Taxpayer ultimately accepted the tender offer from Z, under which Z agreed to acquire all of the outstanding shares of Taxpayer in exchange for e dollars of value in cash and Z common stock (Z Merger Agreement).

Under the Z Merger Agreement, each party made certain representations and warranties. Taxpayer warranted that the Y Merger Agreement had been terminated in accordance with its terms, and that Taxpayer is obligated to pay b and c dollars to Y for the Termination Expenses. The Z Merger Agreement provided that a breach by Taxpayer of any representation, warranty, covenant, or agreement in the Z Merger Agreement that was not curable and that represented a Material Adverse Effect represented grounds for Z to terminate the Z Merger Agreement.

Z agreed to advance funds to Taxpayer to pay the Termination Expenses to Y, repayable by Taxpayer if, under certain circumstances, the Z Merger Agreement was not completed. Taxpayer terminated the Y Merger Agreement, Z paid the Termination Expenses to Y, and Taxpayer signed a promissory note (Note) in the amount of b and c dollars, with a stated interest rate, payable on demand to Z.

Z described the merger as more than the sum of its two parts. Z indicated that it expected to triple its revenue, and that the merger was generating synergies and broadening the customer base of the combined companies.

Taxpayer deducted the Termination Expenses in Cost of Goods Sold on its federal income tax return for the taxable year at issue. No liability was recorded for tax or financial purposes by Taxpayer for the Note, and no payments of principal or interest thereon have been made by Taxpayer. Z accounted for the payment of the Termination Expenses as a contribution of capital to Taxpayer. Taxpayer also deducted f dollars for legal expenses incurred to terminate the Y Merger Agreement.

LAW AND ANALYSIS:

General Background

The ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business are generally deductible under § 162(a). A deduction is also generally allowable for any loss sustained during the taxable year and not compensated for by insurance or otherwise related to abandoned plans for mergers. Section 165(a); § 1.165-2(a); Rev. Rul. 73-580, 1973-2 C.B. 86.

Sections 161 and 261, however, provide in part that the allowance of deductions under §§ 162 and 165 are subject to § 263. Section 263(a)(1) disallows deductions for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Section 263 reflects the basic principle that a capital expenditure may not be deducted from current income. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

In *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), the Supreme Court considered the nature of capital expenditures. The Court rejected the taxpayer's argument that the creation or enhancement of an asset is a prerequisite to capitalization, but instead looked at the nature of the benefits realized by the taxpayer. The Court recognized that "the presence of an ensuing benefit that may have some future aspect is not controlling" in determining whether an expense represents a capital expenditure (citing *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 354 (1971)), and that "the mere presence of an incidental future benefit … may not warrant capitalization," but the Court emphasized that "a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." 503 U.S. at 87.

The Court also indicated that "the 'decisive distinctions' between current expenses and capital expenditures 'are those of degree and not of kind,' and that because each case turns on its special facts the cases sometimes appear difficult to harmonize." 503 U.S. at 86 (citations omitted).[1]

Corporate Merger Expenses

Generally, the expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are capital expenditures. *INDOPCO, Inc. v. Commissioner*, 503 U.S. at 89; *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964).

In *INDOPCO*, the Supreme Court considered whether costs incurred by the taxpayer in a reverse subsidiary cash merger (in which the taxpayer became a wholly-owned subsidiary of the acquiring corporation) were nondeductible capital expenditures. The Court found that the merger produced "significant benefits to [the taxpayer] that extended beyond the tax year in question" and therefore the expenditures were not deductible under § 162(a). 503 U.S. at 88. In particular, the Court pointed out representations in the record that (1) the taxpayer would benefit greatly from the acquiring corporation's enormous resources, (2) some synergy may exist with the acquiring corporation because of the nature of its operations and its strong consumer products orientation, (3) because it was now a wholly owned subsidiary the taxpayer was no longer subject to substantial shareholder relations expenses, and (4) the taxpayer was allowed, in the interests of administrative convenience and simplicity, to reduce the number of authorized shares.

In *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), the taxpayer, faced with a hostile takeover, incurred expenses adopting antitakeover measures, but the taxpayer eventually accepted the tender offer. The court focused on the taxpayer's concerns about the proposed takeover (the suitor had no capital, marketing, or research and development; the suitor intended to abandon the taxpayer's long-term strategic business plans) to find that the taxpayer was "defending against an unwanted acquisition in an effort to maintain and protect an established business," 119 F.3d at 490. The court determined the costs were incurred to frustrate, not facilitate, the merger with the hostile suitor and to preserve the status quo, not to produce future benefits.

In *United States v. Federated Dep't Stores, Inc.*, 171 B.R. 603 (S.D. Ohio 1994), the taxpayers entered into merger agreements with "white knights" to stave off tender offers from a hostile suitor, but despite the taxpayers' efforts the suitor acquired the taxpayers (and the taxpayers paid break-up fees to the white knights). The court found that, unlike the merger in *INDOPCO*, the taxpayers' mergers did not create synergy (especially because the suitor had no experience in the taxpayers' field), but rather the fees were paid as a result of unsuccessful attempts to defend the business from the hostile suitor,

[1] The Internal Revenue Service and the Department of the Treasury have issued capitalization rules at § 1.263(a)-5(c)(8) of the Income Tax Regulations that specifically apply to merger termination payments. However, the regulations are effective only with respect to amounts paid or incurred on or after December 31, 2003, and do not apply in this case.

and therefore the fees were deductible business expenses. The court also found in the alternative that, because the taxpayers did not voluntarily terminate the proposed mergers in order to engage in more favorable mergers, the break-up fees were deductible as losses sustained with respect to an abandoned transaction.

In *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874, 886 (8th Cir. 2000), the court, phrasing the issue as turning on the "origin of the claim doctrine,"[2] considered the tax treatment of employees who, as part of their duties as directors of the employer, performed services indirectly and incidentally related to a corporate acquisition. The court stated that, in applying the origin of the claim doctrine, "the ultimate question is whether the expense is directly related to the transaction [that] provides the long term benefit."

In *Metrocorp, Inc. v. Commissioner*, 116 T.C. 211 (2001), the court, in a reviewed opinion, determined that the entrance and exit fees paid to the F.D.I.C. by the taxpayer upon its acquisition of a failed savings and loan association in a conversion transaction did not provide significant future benefits. In arriving at this conclusion, the court focused narrowly on the nature of benefits arising from the payments standing alone; the court explicitly declined to determine whether the fees should be capitalized in connection with the taxpayer's acquisition of another financial institution. 116 T.C. at 217.

Cancellation of Unfavorable Contracts

Cases involving the deductibility of payments to cancel contracts have looked at the nature of the benefit received by the termination. Generally, the cancellation of a contract does not, in and of itself, require capitalization of the cancellation payment; although the payor enjoys the general benefit of disposing of an unfavorable and burdensome contract and is able to enter into a more favorable contract, these general benefits standing alone do not require capitalization. See *Capitol Indemnity Ins. Co. v. Commissioner*, 237 F.2d 901 (7th Cir. 1956); *Cassatt v. Commissioner*, 137 F.2d 745 (3d Cir. 1943). There are also situations in which a cancellation payment is made specifically to acquire a new benefit, but the cancellation is not connected closely enough to the benefit to require capitalization. In *The 12701 Shaker Boulevard Co. v. Commissioner*, 36 T.C. 255 (1961), the court allowed the taxpayer to deduct a prepayment penalty incurred in paying off existing debt in order to acquire a loan from a new lender. Similarly, in Rev. Rul. 73-146, 1973-1 C.B. 61, a corporation's payments to cancel pre-existing stock options as a condition of a merger agreement were not required to be capitalized.

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[2] The "origin of the claim doctrine," as originally developed, requires a factfinder to determine the tax attributes of legal expenses by looking at the matter being litigated rather than at the indirect consequences of the expenses. See *United States v. Gilmore*, 372 U.S. 39 (1963); see also *Woodward v. Commissioner*, 397 U.S. 572 (1970) (although the cost of stock appraisal, standing alone, may be a deductible expense, the appraisal litigation expenses at issue originated in the acquisition of a capital asset and therefore must be capitalized). Reflecting the general rule that the nature and character of a payment depends on the transaction from which it originated, the doctrine has been invoked in situations not involving litigation expenses (as in *Wells Fargo*).

However, where the cancellation payment is more closely linked to the acquisition of a long-term benefit, courts have treated the payment as a capital expenditure. For example, in *U.S. Bancorp v. Commissioner*, 111 T.C. 231 (1998), a lessee was required to capitalize a lease cancellation payment made in order to enter into a more favorable lease with the same lessor. See also *Basin Electric Power Cooperative v. Commissioner*, T.C. Memo. 2004-109. Similarly, lessors have been required to capitalize lease and license cancellation payments made to reacquire possession of the property. See *Rodeway Inns v. Commissioner*, 63 T.C. 414 (1974); *Peerless Weighing & Vending Machine Corp. v. Commissioner*, 52 T.C. 850 (1969).

In *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*, 273 F. Supp. 229 (D. S.C. 1967), *aff'd*, 393 F.2d 494 (4th Cir. 1968), the taxpayer bottling companies, in order to acquire soft-drink syrup directly from the soft-drink company and avoid the middleman's mark-up, paid the soft-drink company's expenses of acquiring and liquidating the middleman. The taxpayers deducted the expenses as paid solely to eliminate burdensome and onerous contracts. However, the court viewed the payment as made pursuant to an overall plan to improve taxpayer's profits through the acquisition of a more favorable contract to acquire the syrup, the benefits of which could reasonably be expected to continue for an indefinite period.

Discussion

In determining whether payment of the Termination Expenses is a capital expenditure or a deductible business expense, the inquiry must focus on the nature of the benefits realized by Taxpayer upon entering into the Z Merger Agreement and whether the Y Merger Agreement was terminated (and the Termination Expenses were paid) to achieve that benefit.

Although the Termination Expense provisions of the Y Merger Agreement were, in some respects, provided as a defensive maneuver against an unfavorable merger, the Termination Expenses were not paid as a result of a failed defense – rather, they were paid to acquire a significant future benefit.

Clearly the Z Merger Agreement provided long-term benefits to Taxpayer. Taxpayer had initially entered into the Y Merger Agreement because Taxpayer's managers believed the merger would be advantageous, particularly with respect to fending off a combination with X, but the Z Proposal offered additional significant future benefits. As in *INDOPCO*, the Z Merger Agreement was entered into, at least in part, because of anticipated synergies between the two companies. Z's annual report emphasized the benefits expected to be achieved as a result of the merger

The Z Proposal was at no point considered to be a hostile tender offer threatening Taxpayer's business, as was the case in *A.E. Staley Mfg. Co.* and *Federated Dep't Stores, Inc.*; the Termination Expenses were not paid pursuant to an arrangement to fend off suitors in order to maintain the status quo. Rather, Taxpayer pursued, and welcomed, the Z Merger Agreement.

Payment of the Termination Expenses will be treated as a capital expenditure made to achieve the benefit inherent in the Z Merger Agreement if it is *directly related* to the agreement (see *Wells Fargo & Co.*). In this case, Taxpayer and Z contemplated that Taxpayer would cancel the Y Merger Agreement in order to enter into the Z Merger Agreement – it was a condition of the merger. Further, the termination provision in the Y Merger Agreement specified that Taxpayer could terminate the agreement, and would be required to pay the Termination Expenses, *in order to enter into a binding written agreement concerning a Superior Proposal*. Otherwise, Taxpayer's board of directors was required (in the absence of mutual consent, breach, or other specified conditions) to recommend that shareholders approve of the Y Merger Agreement. Accordingly, the Y Merger Agreement was terminated, and the Termination Expenses were paid, specifically to enter into the Z Merger Agreement. These facts are significantly different from those found in *The 12701 Shaker Boulevard Co.*, discussed above, where expenses incurred to cancel an existing contract were not found to be closely related to the new contract; the facts are also different from those in *Federated Dep't Stores, Inc.*, where the court found that the terminated merger was a separate transaction from the subsequent merger. The payment of the Termination Expenses bears a direct relationship to the Z Merger Agreement.

The Y Merger Agreement was entered into because Taxpayer's board of directors determined that it would be in the best interest of Taxpayer and its shareholders. Unlike *Capitol Indemnity Ins. Co.* and *Cassatt*, but more like *Darlington-Hartsville Coca-Cola Bottling Co.*, *U.S. Bancorp v. Commissioner*, *Rodeway Inns*, and *Peerless Weighing & Vending Machine Corp.*, Taxpayer terminated the Y Merger Agreement, and paid the Termination Expenses, specifically to acquire a benefit (the synergies promised by the Z Merger Agreement) that, absent termination, would not be available.

Because Taxpayer's payment of the Termination Expenses is directly related to the Z Merger Agreement, and because the Z Merger Agreement confers significant future benefits upon Taxpayer, payment of the Termination Expenses is a capital expenditure. The Termination Expenses, therefore, are not deductible expenses, but rather they must be capitalized under § 263.

CAVEAT(S):

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