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Failed Deal Costs: Capitalize or Deduct?

By Robert W. Wood • Wood & Porter • San Francisco

Learning from your mistakes is supposed to be a good thing. We all try to do it. Yet, paradoxically, mistakes in acquisition negotiations—and even plain old changes of heart—may end up having a bitter tax cost. At least that's how the IRS may try to spin it.

In a case from Al Capone's time, *Portland Furniture Manufacturing Co.*, 30 BTA 878, Dec. 8592 (1934), the IRS argued that costs of a failed merger were not deductible in the year the taxpayer incurred them. Instead, said the IRS, they were deductible in the following year when the taxpayer eventually completed the merger. Since the taxpayer gained knowledge and received a benefit from the failed merger, the IRS argued the costs of that failed merger should be capitalized.

Fortunately, the court disagreed, determining that the costs of the failed merger were deductible in the year they were incurred. After all, the court said, the costs were "separate and distinct" from the costs associated with the subsequent successful merger.

Old Theories Die Hard

More recently, in a Technical Advice Memorandum, the IRS determined that termination fees paid to end a proposed merger were capital expenditures. The taxpayer in TAM 200512021 (Dec. 29, 2004) was a hopeful buyer who entered into a merger agreement with a prospective seller. The merger agreement contained termination provisions allowing the taxpayer to opt out of the merger for a fee. During negotiations with the seller, the taxpayer invested costs into a superior business proposal, which it subsequently accepted. After deciding to accept the superior proposal, the taxpayer terminated its agreement with the seller and paid the termination fee.

Like most people would, this taxpayer deducted the termination fee, claiming the deduction under Code Sec. 162 as a buyout fee. Interestingly, the taxpayer fully disclosed the issue on a Form 8275.

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The IRS disallowed the deduction, stating that the termination fee was a nondeductible capital expenditure related to the taxpayer's subsequent transaction.

The taxpayer then requested technical advice from the IRS.

The Times They Are a Changin'

The IRS responded with TAM 200512021, in which the IRS determined that the taxpayer's payment of the termination fee was directly related to the superior proposed transaction. Plus, because the superior deal seemed to confer significant future benefits to the taxpayer, the IRS said the termination fee was a capital expenditure. The IRS focused primarily on the relationship between future benefits and current costs.

In a sort of inverted approach, the IRS supported this decision with several cases in which the costs of failed mergers were *allowed* to be deducted, but had *no relevant* effect on a *subsequent* merger. [*See Federated Department Stores, Inc.*, DC-OH, 94-2 USTC ¶50,430, 171 BR 603 (1994); *A.E. Staley Manufacturing Co.*, CA-7, 97-2 USTC ¶50,521, 119 F3d 482 (1997); and *Metrocorp, Inc.*, 116 TC 211, Dec. 54,308 (2001).] The taxpayers in those cases deducted costs paid to hold off hostile takeovers.

Bad Facts, Bad Law?

More than a few M&A TAX REPORT readers may be scratching their heads over the fact that the IRS is citing these cases. After all, these were *good* cases for taxpayers. In a leap of logic, the IRS posits the rationale that taxpayers who want to stay with the *status quo* do not incur a future benefit. Thus, the IRS says, the costs they incur (to stay the same) are deductible.

Still, it is arguable that costs to stay the old course versus costs to change or alter a current business practice both equally affect the future of a company. The IRS hones in on the presence of a *new benefit* to the taxpayers' current business practice. Thus, on one level, TAM 200512021 appears to be in line with *INDOPCO*.

Yet, it is arguable that the IRS has materially increased its scope. The TAM points out that in *INDOPCO*, SCt, 92-1 USTC ¶50,113, 503 US 79 (1992), the Supreme Court determined that the presence of an ensuing benefit that may have some future aspect is not controlling on whether an expense must be treated as a capital expenditure. [*See also Lincoln Savings and Loan Assoc.*, SCt, 71-1 USTC ¶9476, 403 US 345, 354 (1971).] *INDOPCO* says that "the mere presence of an incidental future benefit ... may not warrant capitalization."

However, 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 [an] immediate deduction or capitalization." Yup. Admitting of the difficulty in making these slippery slope determinations, the Court found that the decisive distinctions between current and capital are those of degree, not of kind. Indeed, because each case turns on its facts, the Supreme Court out and out admitted that the cases appear difficult to harmonize.

INDOPCO also held that expenses incurred for the purpose of changing a corporate structure for the benefit of future operations are capital.

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Are costs incurred by a taxpayer in a reverse subsidiary merger nondeductible capital expenditures? The Supreme Court found that the merger produced significant benefits extending beyond the tax year. Therefore, the expenditures were not deductible.

The Supreme Court noted several facts it used to make its determination:

- The extent a taxpayer would benefit from the acquisition of the target's resources
- The level of synergy that might exist with the acquiring target corporation
- Whether the taxpayer is allowed to reduce its number of authorized shares to ease administrative burdens

Termination payments made to acquire a new benefit can require capitalization, even if the termination payments are not closely connected to that new benefit. But, you may get lucky. In *12701 Shaker Boulevard Co.*, 36 TC 255, Dec. 24,825 (1961), the court allowed a taxpayer to deduct a prepayment penalty incurred in paying off existing debt, even though the payoff permitted the taxpayer to acquire a new loan from a lender.

However, if cancellation payments are closely linked to the acquisition of a "long-term benefit," courts are likely to treat the payment as a capital expenditure. Thus, in *U.S. Bancorp*, 111 TC 231, Dec. 52,871 (1998), a taxpayer 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*, 87 TCM 1266, Dec. 55,627(M), TC Memo. 2004-109 (2004).]

Picking Partners

In TAM 200512021, the taxpayer terminated its merger agreement precisely so as to accept the superior proposal. However, the taxpayer was not yet fully engaged in a business deal that it later cancelled. That may be an important difference.

In both *Shaker Boulevard* and *U.S. Bancorp*, the taxpayers were *already* engaged in a business deal when the taxpayers incurred costs to withdraw from those deals. In TAM 200512021 the taxpayer was paying a fee to avoid a transaction, and *not to* enter into that transaction at all. On some level, this may be more akin to losing a security deposit rather than paying fees to cancel an existing business transaction.

TAM 200512021 also stated the following:

> 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 do not require capitalization.

That's at least a crumb of solace. But, as an infomercial would say, "Wait, there's more!" The TAM notes that nothing in the record suggests the taxpayer would have suffered any economic detriment had it completed the merger with its original target, nor that the taxpayer would have extricated itself from the first agreement if there had been no second deal. In other words, this is a kind of "but for" causation.

Notably, it appears to be contradicted by at least some of the facts in the ruling. The TAM explained that one of the significant shareholders had expressed concern that the original merger was not in the best interests of the shareholders. Thus, he requested and received permission to develop a subsequent proposal, which led to the superior proposal.

Nevertheless, the IRS ultimately concluded that the termination fee was paid to acquire a benefit that would not otherwise have been available to the taxpayer. This seems odd, since the facts suggest that the initial merger was not fully developed, and that the taxpayer was constantly searching out new business transactions.

To me, it's therefore hard to swallow the IRS's conclusion that the termination fee was paid for a benefit that was not otherwise available, merely because one deal sort of led to another. After all, any business engaged in a single industry may entertain multiple (yet similar) deals during a given time period. Is the next step to argue that all transactions are somehow related?

Is Patience a Virtue?

Reg. §§1.263(a)-4 and (a)-5 govern which transaction costs paid after December 31, 2003, might be currently deductible, and which have to be capitalized. The termination fees involved in TAM 200512021 seem to fall under Reg. §1.263(a)-5(c)(8), which covers termination payments and amounts paid to facilitate mutually exclusive transactions. Termination payments under this regulation are treated as nondeductible costs paid to facilitate a second transaction, only if the transactions are "mutually exclusive." A "mutually exclusive" event occurs where the occurrence of any one event automatically implies the nonoccurrence of the other.

In TAM 9402004 (Sept. 10, 1993), three brothers who controlled 72.5 percent of a corporation decided to sell off their interest. The corporation retained an adviser who developed a list of prospective buyers. Two of the three brothers played major roles in the due diligence process. The corporation later deducted six-sevenths of its financial, legal, accounting, internal payroll, and other costs of its eventual sale.

The taxpayer argued that it abandoned its merger transactions with the other potential buyers when it was finally acquired. The taxpayer said this entitled it to deduct its expenses related to the failed transactions. The IRS disagreed, ruling that a taxpayer engaged in a series of transactions who later abandons one of those transactions, is allowed a loss, even if the taxpayer later proceeds with a similar transaction.

The IRS cited several cases that allowed a deduction for the abandonment of a separate and distinct transaction even if subsequent or alternative independent transactions were pursued. If proposals are alternatives, only one of which can be completed, then the IRS says no abandonment loss is proper unless the *entire* transaction is abandoned. Abandonment losses are not allowed for proposals that are mutually exclusive alternative methods of reaching a desired financial position. [*See Tobacco Products Export Corp.*, 18 TC 1100, 1104, Dec. 19,208 (1952); and *Doernbecher Manufacturing Co.*, 30 BTA 973, Dec. 8606 (1934), *acq.* XIII-2 CB 6, *aff'd*, CA-9, 36-1 USTC ¶9030, 80 F2d 573 (1935).]

Note. A taxpayer may want to document the abandonment of any of its transactions. The IRS has a clear motive to argue for capitalization of costs. Therefore, taxpayers have an incentive to substantiate the abandonment of any transactions to support deducting costs associated with these abandoned transaction.

However, Reg. §1.263(a)-5(e)(8) provides that employee compensation, which includes guaranteed payments to partners and annual compensation paid to corporate directors, is not included in the amount paid to facilitate a mutually exclusive transaction. In addition, *de minimis* costs up to an aggregate of $5,000 may be expensed. Furthermore, the regulation established a cutoff date before which expenses that facilitate a transaction need not be capitalized. The date is the earlier of:

(i) the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or

(ii) the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) the date determined under this paragraph (e)(1)(ii) is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.

The regulations cut out costs that are "inherently facilitative amounts," such as appraisals, fairness opinions related to the transaction, costs of structuring the transaction (which includes negotiating its structure and obtaining tax advice), and the costs of preparing and reviewing documents that support the transaction. Therefore, based on all the facts and circumstances of the transaction, the nature of the costs should be analyzed, to determine whether those costs facilitated a deal.

Conclusion

Virtually any taxpayer engaging in corporate transactions faces questions whether costs are deductible or must be capitalized. In some instances, it will be clear that the expenses directly benefiting the future must be capitalized. However, costs that only produce a general or incidental benefit do not necessarily require capitalization. Far from black and white, the real world is filled with gray.

Costs that lead to some benefit may require capitalization, but taxpayers will often find themselves spinning the facts as best they can to avoid this result. Plainly, the facts and their amorphous linkage to the future can be subject to different interpretations. The facts may be capable of being spun in one of several different ways.

In weighing such issues, timing can be key. If in TAM 200512021 the superior proposal came along *two years* after the significant shareholder recommended that the taxpayer terminate the merger agreement, would the IRS have claimed that the costs incurred two years prior required capitalization? Perhaps not.

Taxpayers will be faced with many positions that are different from the scenario painted in TAM 200512021. Timing is critical, the facts are critical and the facts may even be capable of examination in one of several different ways.

Good luck out there!