To Deduct or Not to Deduct: The Cost of an IPO

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Most readers of THE M&A TAX REPORT know that if you ask the IRS about the deductibility of costs incident to an IPO, there is likely to be a simple and straightforward answer: "No." That is just what happened in Technical Advice Memorandum ("TAM") 200532048 [Tax Analysts Doc. No. 2005-17168, 2005 TNT 156-13]. Even though the taxpayer there had a colorable position based on an extension of a 1999 revenue ruling, the IRS took a no-deduction stance.

In TAM 200532048, the taxpayer was a consolidated group that emerged from a complicated transaction. Corporation A was the parent and its stock was not listed or traded. It underwent an IPO and subsequently, the IRS examined its returns. During the examination, a company filed a claim for refund, requesting that certain "pre-decisional and investigatory" IPO costs and "other deductible" costs not previously deducted be allowed as deductions. Essentially, the taxpayer claimed that all costs incurred before its board of directors approved the IPO should be considered pre-decisional and investigatory. These costs included fees paid to investment bankers, lawyers and accountants.

The taxpayer was not able to substantiate costs incurred prior to the board approval. In its claim for a deduction, it asked for a percentage of the total IPO costs to be allowed as a deduction in what seems to be a linear, time based methodology. The lack of substantiation did not seem to affect the IRS's analysis. "No" is still "no."

Old News?

It is axiomatic that stock issuance costs are not deductible. [*See McCrory Corp.*, CA-2, 81-2 USTC ¶9499, 651 F2d 828 (1981).] Going back more than 80 years, the case law has consistently held that the costs of issuing and marketing stock simply diminish the net return from the stock issuance. The fact that there are marketing costs is, in effect, simply the equivalent of selling the stock at a discount.

Based on the learning of *INDOPCO* [SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039] and its progeny, the taxpayer in TAM 200532048 apparently took the position that many of these costs were pre-decisional investigatory costs and sought to deduct them. The taxpayer seems to have analogized its situation to the situation described in Rev. Rul. 99-23 [1991-1 CB 998]. Rev. Rul. 99-23 describes investigatory costs incurred in connection with the acquisition of a new trade or business, and treats some of these costs as eligible for amortization under Code Sec. 195. The idea, of course, is that expenditures incurred before the establishment of an active business are effectively deemed paid or incurred in the operation of an existing trade or business (in the same field). That could make some of them deductible.

Rev. Rul. 99-23 holds that expenditures incurred in the course of a general search for (or investigation of) an active trade or business in order to determine *whether* to enter a new business (and *which* new business to enter) qualify as investigatory costs that can be amortized as startup expenditures. Still, there is a good deal of line-drawing here. In fact, expenditures incurred in connection with an attempt to acquire a *specific* business do not qualify as startup expenditures (and hence are not amortizable). They are acquisition costs under Code Sec. 263.

Leaving No Stone Unturned

Rev. Rul. 99-23 expands on the foundation established by Rev. Rul. 77-254 [1977-2 CB 63]. That ruling considered costs incurred in the potential acquisition of a new business, including the cost of advertisements in newspapers, travel expenses to check out prospective targets and auditing potential acquisition targets. Eventually, the taxpayer decided to purchase a specific business and retained a law firm to draft the necessary purchase documents.

The taxpayer ultimately abandoned its attempt to acquire the specific target business, and reported a loss under Code Sec. 165. The ruling states that the expenses incurred in the course of a general search for (or preliminary investigation of) a business or investment are in one category. Basically, these include the costs of deciding whether to enter a transaction and, if so, which one. However, once the taxpayer has focused on the acquisition of a specific business or investment, the expenses that are related to an attempt to acquire that business or investment are in another category. That latter category is capital in nature.

Rev. Rul. 77-254 concludes that costs paid or incurred to acquire the specific business which was ultimately abandoned were deductible. However, the expenses for advertisements, travel to search for a new business and audits to help the taxpayer to decide whether to attempt an acquisition were investigatory expenses and were not deductible. The taxpayer was not, after all, already carrying on the relevant trade or business. Of course, in Rev. Rul. 99-23, such investigatory expenses became deductible as startup expenditures under Code Sec. 195.

Wells Fargo

In *Wells Fargo & Co.* [CA-8, 2000-2 USTC ¶50,697, 224 F3d 874 (2000), *aff'g in part* and *rev'g in part, Norwest Corp.*, 112 TC 89, Dec. 53,277 (1999)], the Eighth Circuit Court of Appeals applied this kind of analysis in determining whether the expenditures of expanding a business through merger could be deducted. *Wells Fargo* involved the deductibility of a target's investigatory costs incurred in connection with a corporate consolidation. The Tax Court held that the investigatory costs were required to be capitalized, even though they were incurred *before* the decision to consolidate was made. The Tax Court found that these tainted expenses were "sufficiently related" to an event that produced a significant long-term benefit.

After Rev. Rul. 99-23 was published, during the Eighth Circuit's consideration of the *Wells Fargo* case, the IRS conceded the deductibility of legal expenses attributable to the investigatory stage of the transaction. Not surprisingly, the Eighth Circuit agreed that investigatory expenses that post-dated the final decision to consolidate would have to be capitalized.

It should come as no surprise that just about all of the historical discussion here focuses on differentiating those expenses that are deductible or amortizable from those that must be capitalized to the cost of acquiring the property. According to TAM 200532048, this logic has no application to stock issuance costs.

TAM 200532048 takes the position that the "whether and which" analysis ("whether to purchase a business and which business to purchase") of Rev. Rul. 99-23 and Rev. Rul. 77-254 is not appropriate for determining the deductibility of stock issuance costs. Stock issuance costs, says the TAM, are not capitalized to any specific tangible or intangible assets. Instead, they simply reduce the proceeds, as if the stock had been sold at a discount. [*See Affiliated Capital Corp.*, 88 TC 1157, Dec. 43,894 (1987).]

In contrast, the "whether and which" analysis for the expansion of a business and for acquisition costs seeks to differentiate expenses that are deductible (or amortizable) from those that must be capitalized to tangible or intangible assets that are acquired in the transaction. Thus, in the stock issuance cost arena, there is no reason to distinguish "predecisional investigatory costs" that are related to stock issuance from other stock issuance costs. All of the costs that are sufficiently connected to a corporation's issuance of its stock are nondeductible offsets against the proceeds that are received from the stock sale.

The TAM cites various authorities for the proposition that the "whether and which" investigatory cost analysis is inapplicable to stock issuance costs. [*See* Reg. §1.263(a)-5.]

Last Nail

The IRS re-enunciates what it says is the long-standing rule that stock issuance costs are nondeductible, regardless of whether they are incurred before or after the date the taxpayer makes a final decision to enter into the stock issuance transaction. The TAM concludes that the taxpayer cannot deduct any of the costs it incurred in connection with the IPO, regardless of whether some of these costs could fairly be characterized as "pre-decisional and investigatory" costs. So what else is new?

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