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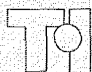

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Can GE Capital Deduct Its Kemper Takeover Bid Costs?

by Robert Willens • Lehman Brothers and Robert W. Wood • San Francisco

GE Capital's bid to gain control of Kemper has created another spurt of interest in the tax status of expenses incurred in takeovers. GE Capital apparently began this exercise months ago through informal talks with Kemper's management. However frosty Kemper's reception may have been to GE's overtures (it first officially rejected a GE proposal on 3/4/94), Kemper's actions have only served to increase GE's resolve to attain what it feels is the ideal company through which to become a force in the mutual fund industry.

Accordingly, GE went public with its $55 per share bid for Kemper on 3/14/94, but Kemper has continued to say "no." Nevertheless, after much public outcry from both GE and large Kemper shareholders, GE launched a proxy fight, and proposed a roster of four potential Kemper directors (all former GE executives) to be voted on at Kemper's annual meeting on 5/11/94. Sentiment suggests that should shareholders give the nod to GE via the election of these candidates, Kemper will be forced to accept GE's offer. The market has smiled on this proposed union, as evidenced by the more than 20-point rise in Kemper's stock since GE's intentions became known.

Many Expenses

Regardless of this drama's outcome, many expenses will be incurred, the deductibility of which is in doubt. The situation is an ideal example with which to provide an overview of the status of merger expense taxation.

Guidance on the tax treatment of expenses incurred in an acquisition is primarily found in *INDOPCO, Inc.*, 112 S. Ct. 1039 (1992). (For coverage, see "IRS Aggressively Expands *INDOPCO*," 1 *M&A Tax Rep't* 10 (May 1993), p. 5; "The Continuing Flap Over Expenses—Takeover and Otherwise," 1 *M&A Tax Rep't* 3 (October 1992), p. 7; and "*INDOPCO*, *Federated*, and Beyond," 1 *M&A Tax Rep't* 1 (August 1992), p. 1.) That case arose from a transaction involving Unilever's acquisition of National Starch and Chemical (the company was renamed INDOPCO following the acquisition).

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National Starch incurred significant expenses, primarily investment banking fees, legal fees, and accounting fees, as a result of the deal. Accordingly, the relevant question in that friendly merger was whether National Starch could deduct the fees.

Ordinary and Necessary to Whom?

For an expense to be deductible, it must be considered an ordinary and necessary business expense. The volumes of interpretation that have gone into defining the phrase "ordinary and necessary" is staggering, yet the stakes are high. If an expense is capital in nature, it can *never* be deducted as an ordinary and necessary business expense. At best, capital expenditures can only be amortized over the life of the related asset. The issue in *INDOPCO* was whether the expenses related to the acquisition were ordinary or capital expenditures. Prior to *INDOPCO*, the prevailing school of thought was that an otherwise ordinary expense was a capital expenditure *only* if it created or enhanced a separate and distinct additional asset. Counsel for *INDOPCO* argued that no separate or distinct additional asset was created in the merger, nor was one enhanced. Absent an asset being created or enhanced, the argument went, these expenses could not be capital and therefore, were deductible.

Unfortunately for Unilever, in each stage of trial, the courts agreed that while creating or enhancing a separate asset is clearly sufficient grounds on which to rule an expense capital, it is not a prerequisite. The courts felt that there were other ways in which an expense could reach the status of being capital.

In particular, when an expenditure results in a long-term benefit (*i.e.*, a benefit that can be expected to extend beyond the year in which the expense occurs), the expenditure is capital regardless of whether a separate and distinct asset is being created or enhanced. In *INDOPCO*, the courts were able to find long-term benefits from the transaction, and therefore, the expenses were capital.

After *INDOPCO*

In the *INDOPCO* transaction, there were obvious long-term benefits: synergies were created through the joining of Unilever and National Starch, and National Starch could tap into the expansive resources that a large firm like Unilever had. In fact, once the Supreme Court determined the existence of these benefits, the test for capitalization was completed. The *INDOPCO* deal would, by definition, have to produce long-term benefits for National Starch, or its board of directors would have been negligent in recommending it.

Consequently, in the wake of *INDOPCO*, almost every expense that previously was viewed as clearly deductible must be reevaluated in light of the Court's broad test for capitalization. This situation has resulted in the IRS having to publish guidance on practically every expense that comes up. For example, with regard to leveraged buyouts, the IRS' current position is that the mere change in corporate status from that of a public corporation to a private one creates a long-term benefit, evidenced by the fact that the company must no longer incur the costs of annual SEC filings.

No Affect on Incidental Repair Costs

However, the Service has also ruled, in *Rev. Rul.* 94-12, 1994-8 IRB 5, that *INDOPCO* has no effect on the treatment of incidental repair costs (*i.e.*, costs that have been taken as a given to be deductible business expenses). The touchstone for deductible incidental repairs is that they keep the property in ordinary operating condition and neither materially add to the value of the property nor appreciably prolong its life. Conversely, costs that either increase the property's basis, or that are incurred to appreciably prolong the life of the property, must be capitalized. The meaning of words such as "appreciably" can obviously be sticky.

Section 263(a) and Reg. 1.263(a)-1(a) provide

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that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property, or for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made in the form of a deduction for depreciation, amortization, or depletion. Further, Reg. 1.263(a)-1(b) provides that capital costs include amounts that: (1) add to the value or substantially prolong the useful life of property, or (2) adapt property to a new or a different use. However, the same section provides that amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of Section 263(a).

The Service in *Rev. Rul.* 94-12 concludes that *INDOPCO* does not affect the treatment of incidental repair costs, even though such costs may have some future benefit. The Service cites a paucity of prior rulings dealing with the distinction, seemingly making clear that (1) old authority dealing with the question whether repair costs involve more than simply a potential future benefit or are deductible continue to be relevant, and (2) it had no wish to rehash that voluminous area in the ruling.

No Victory

The case for deducting *merger* expenses becomes more unclear when one looks at *Victory Markets, Inc.*, 99 TC No. 34 (1992). The facts in that case were not too far from those in the current struggle between Kemper and GE. In *Victory Markets*, an unsolicited offer was made for the company, which was initially rejected. However, when the offer price was later increased, it was accepted. Between the rejection and the acceptance of the higher offer, the company adopted (although it never activated) a poison pill plan.

The expenses involved in *Victory Markets* were similar to those in *INDOPCO*, but the company sought a deduction on the theory that the deal was not friendly and that *INDOPCO's* reach was limited to expenses incurred in a friendly deal. Nevertheless, the Tax Court ruled that this was a friendly deal, because the offer was made subject to board approval, and the acquiror never attempted to circumvent the board by making a tender offer directly to the shareholders. The court dismissed the fact that there had been a poison pill involved, noting that the pill plan was never activated, and was adopted strictly as a "bargaining enhancer." Consequently, it appears that, following *Victory Markets*, an unsolicited offer is considered friendly *unless* it is made via a tender offer.

This conclusion leaves the parties involved in such an exercise with the challenge of determining at what point expenses become deductible once the offer turns "hostile." Are expenses incurred before a tender offer is launched considered tied to a "friendly" offer and therefore not deductible, while those incurred after the tender offer are deductible? Or, are *all* the expenses linked to the takeover deductible once the offer is judged hostile? The IRS seems to be attempting to skirt the issue, by saying that these expenses are generally *never* deductible. Their view, sure to be challenged in court, is that such expenses produce a long-term benefit, even where (1) the offer is judged to be hostile, and (2) it is successfully repelled.

Proxy Fight Costs

Now that GE has started a proxy fight with Kemper, the conclusion is a little simpler. The courts have determined, and the IRS has concurred (see *Rev. Rul.* 67-1, 1967-1 CB 28), that expenses incurred in a proxy fight are deductible, because such expenditures do not produce any long-term benefits. The target company, by attempting to ward off the suitor, is working only to preserve the status quo. This long-standing position on proxy fight expenses seems impossible to reconcile with the IRS' new position regarding hostile takeover expenses adopted in the wake of *INDOPCO*.

At this juncture in Kemper and GE's battle of wills, expenses resulting from the proxy fight clearly have the best chance of being deductible. Questions remain about expenses incurred up to this point, and about expenses that will be generated subsequently that are unrelated to the proxy fight. The situation would be further complicated if GE launched a tender offer.

Given the company's desire to avoid blackening its name through such an unsightly move, however, it is unlikely that it will try this maneuver. Nevertheless, at present, both the deductibility of expenses and Kemper's future as an independent entity are clearly up in the air. ■