

US IRS rules target's capitalized transaction costs do not create a separate and distinct intangible asset

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In technical advice memorandum [202004010](#) (the TAM), the United States (US) Internal Revenue Service (IRS or Service) ruled professional and administrative fees paid by a Target corporation in connection with the acquisition of its stock by Taxpayer did not create a separate and distinct intangible asset and were not deductible as a loss under Internal Revenue Code¹ Section 165 by Target upon the subsequent sale of Target's stock by Taxpayer.

Facts

Taxpayer acquired Target's stock in a taxable reverse triangular merger. As part of the acquisition, Target paid professional and administrative fees to law, accounting, investment and other professional firms and the Securities and Exchange Commission.

Target determined that a certain portion of the fees were paid as part of Taxpayer's investigation and pursuit of the acquisition and were required to be capitalized as costs of facilitating the acquisition of Target's trade or business under Treas. Reg. Section 1.263(a)-5(a). Additionally, Target determined that a portion of the fees were success-based fees under Treas. Reg. Section 1.263(a)-5(f) and used the Revenue Procedure 2011-29 safe harbor to allocate the success-based fees between facilitative and non-facilitative costs. Target capitalized the facilitative costs as an intangible asset.

Taxpayer later sold Target to Buyer, which resulted in a capital loss. Taxpayer claimed a Section 165(a) loss deduction for Target on its consolidated corporate tax return and reduced Target's separate taxable income by the value of the administrative and professional fees capitalized under Section 263(a). It then included Target's separate taxable income in its consolidated taxable income under Treas. Reg. Section 1.1502-11(a)(1).

Following the investment adjustment rules of Treas. Reg. Section 1.1502-32, Taxpayer reduced its basis in Target's stock by the amount the Section 165(a) deduction reduced Target's separate taxable income. The adjustment resulted in Taxpayer having a lower basis in Target's stock and a reduced capital loss on the sale of Target.

Analysis

Issue 1: Did the professional and administrative fees create a separate and distinct intangible asset under Treas. Reg. Sections 1.263(a)-4(b)(1)(iii) and 1.263(a)-4(b)(3)(i)?

Under Treas. Reg. Section 1.263(a)-4(b)(1)(iii), a taxpayer must generally capitalize an amount paid to create or enhance a separate and distinct intangible asset. Under Treas. Reg. Section 1.263(a)-4(b)(3)(i), the term "separate and distinct intangible asset" means "a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business."

Treas. Reg. Section 1.263(a)-5 requires a taxpayer to capitalize an amount paid to facilitate a business acquisition or reorganization transaction described in Treas. Reg. Section 1.263(a)-5(a), including, among other transactions, an acquisition of an ownership interest in the taxpayer. Treas. Reg. Section 1.263(a)-5(g) expressly reserves on the treatment of target's facilitative costs in a taxable stock acquisition.

Taxpayer argued that Target paid the professional and administrative fees to create a separate and distinct intangible asset in the form of the synergistic benefits that Target expected to receive from its combination with Taxpayer. Further, Taxpayer stated that this conclusion is consistent with the Supreme Court's analysis in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 86-90 (1992), which reasoned that professional expenses incurred by a target corporation

in the course of a friendly takeover must be capitalized, in part, because of the synergistic benefits expected to be generated in the future by combining the target's and acquirer's businesses.

Additionally, Taxpayer argued that, by not providing regulations specifically addressing the treatment of a target's capitalized facilitative costs in taxable stock acquisitions, the IRS has implicitly sanctioned alternative treatments, such as "treating such costs as creating a new asset the basis of which may or may not be amortizable."

The IRS Field Office acknowledged that Taxpayer correctly observed that Treas. Reg. Section 1.263(a)-5(g) specifically reserves, and therefore does not address, the treatment of Target's costs capitalized in a taxable stock acquisition. Nevertheless, the absence of regulations does not imply that any particular treatment is correct. Rather, the IRS Field Office argued, and the National Office agreed in the TAM, that the treatment of Target's fees is clearly addressed by the Section 263 regulations and longstanding case law, including the Supreme Court's analysis in *INDOPCO*.

Specifically, under the regulations, the fees paid by Target are not capitalizable as amounts incurred to acquire or create a separate and distinct intangible under Treas. Reg. Section 1.263(a)-4. Rather, Treas. Reg. Section 1.263(a)-5 governs the application of Section 263(a) to Target's costs.

Further, in *INDOPCO*, the Supreme Court made clear that the professional and administrative fees were incurred for the target corporation's restructuring, as well as its continuing operations and betterment, for the duration of its existence, and not for the acquisition of an asset that was separate and distinct from its ongoing business. The Court also observed that capital expenditures are normally amortized or depreciated over the life of the asset. If there is no specific asset or useful life cannot be determined, the expenditures are deducted when the enterprise is dissolved.

Consistent with *INDOPCO*, the Service determined that the facilitative costs were incurred to acquire significant future benefits for Target's business and operations. Accordingly, the costs should be capitalized, not as costs incurred to create or enhance a separate and distinct intangible, but rather as fees incurred to facilitate Target's restructuring under Treas. Reg. Section 1.263(a)-5.

Issue 2: Did Taxpayer properly claim a loss deduction under Section 165(a) for the professional and administrative fees for the tax year in which Taxpayer sold all of its Target stock to Buyer, an unrelated third party?

Taxpayer argued that Target's previously capitalized fees are deductible as a loss to Target under Section 165 because the asset created by the capitalization of these fees (i.e., the synergistic benefits), became worthless to Target when Taxpayer sold Target's stock. Taxpayer contended Target's subjective determination that its asset was worthless was evidenced by Taxpayer's announcement that it planned to divest Target's business, and the identifiable event occurred, and the loss was sustained, when the Taxpayer sold Target's stock to Buyer.

The Service disagreed, first noting the payment of the fees "did not create or enhance an intangible asset separate and apart from Target's business, but rather were incurred to benefit Target's trade or business." Second, if the purpose of the expenditure has to do with the enhancement of a corporation's operations, then the useful life of the expenditures would be measured by the duration of those operations. Accordingly, a taxpayer generally could not recover these costs until the dissolution of the business enterprise or until the occurrence of another event that ends the useful life of the business.

In this case, Taxpayer has not: (1) shown that Target abandoned its business or dissolved its business operations; and (2) provided evidence that Target determined its business was worthless. The Service also stated that assets "may not be considered worthless, even when they have no liquidated value, if there is a reasonable hope and expectation that they will become valuable in the future."

In looking at Taxpayer's sale of Target to Buyer, the Service concluded that, while the sale may have been a taxable event for Taxpayer, it did not represent a transaction for which Target could claim a loss under Section 165. After the sale, Target continued as a corporation and operated its business under Buyer. Because Taxpayer did not show that Target was worthless or that the sale to Buyer resulted in a closed and completed transaction for Target's business, the Service concluded that Target was not entitled to a loss under Section 165 and, therefore, Taxpayer must recompute several items reported on its consolidated return. The Service determined that Taxpayer must increase: (1) Target's separate taxable income; (2) Taxpayer's consolidated income; and (3) Taxpayer's basis in Target. The Service noted that the increase to the basis will result in an increased capital loss from Target's sale.

Related authorities

The conclusions reached in the present TAM are consistent with prior Service guidance on a similar issue in TAM 200502039 (01/14/2005). In TAM 200502039, a subsidiary of the parent company acquired the stock of a target corporation in a taxable transaction. The target capitalized the acquisition's transaction costs under Section 263. Subsequently, the target transferred its assets and liabilities in a Section 332 liquidation to the subsidiary and dissolved under state law, while the subsidiary continued the target's operations. The parent then claimed a deduction for the transaction costs under Section 165, arguing the rationale of *INDOPCO* supported the position that the capitalized transaction costs could be deducted under Section 165 when a corporation was liquidated via state law dissolution. The IRS rejected the taxpayer's first argument. In emphasizing that costs are not deductible until the trade or business actually ceases, the Service said, "Instead, we would interpret the phrase 'dissolution of the enterprise' to also encompass the discontinuation of the acquired corporation's operations and activities, as being the more consistent point in time at which the benefits identified by the Court as arising from these expenditures cease to exist."

The IRS's approach in the TAMs is also consistent with the language in *INDOPCO* ("While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise." *INDOPCO*, 503 U.S. 79, 84 (1992)).

Implications

In the absence of guidance on the treatment of capitalized transaction costs, the IRS is likely to consider that a target's capitalized costs are not recoverable until the trade or business ceases or the target otherwise dissolves. Taxpayers are encouraged to seek advice or analyze carefully to see if portions of the costs may be recovered at an earlier date, such as when the target operates several lines of business and disposes of one of the lines of business.

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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