Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-4228-00
YMPeters

date:

to: Marge Lopez
Team Coordinator, CT&M 1285

from: Associate District Counsel, Southern California District, San Diego

subject: [redacted]
[redacted] Cycle

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to the attorney-client and deliberative process privileges and, if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to persons beyond those specifically indicated in this statement or to taxpayers or their representatives.

This advice is not binding on the Internal Revenue Service and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memo is in response to your request for updated, general information about the treatment of costs incurred as part of a consolidation.

ISSUE

Whether the taxpayer's costs incurred in effectuating an I.R.C. § 368(a)(1)(A) statutory consolidation are deductible as current expenses or are non-deductible capital expenses.

CONCLUSION

Additional information is required to make a determination in this case. The details of the services and advice provided to the taxpayer, including the timing of the activities, need to be obtained in order to determine whether certain of the expenditures are not sufficiently connected to the consolidation and therefore may be deductible. In general, expenditures

incurred in connection with a statutory reorganization are capitalized.

FACTS

Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

In [redacted], [redacted] and [redacted] announced an agreement to consolidate.[1] The consolidated entity was called [redacted]. Subsidiaries of [redacted] called [redacted] and [redacted] were created. Prior to the consolidation, [redacted][2] the taxpayer, was a subsidiary of [redacted]. After the consolidation, it became a second-tier subsidiary of [redacted] under the new subsidiary [redacted].

The consolidation took place via a statutory I.R.C. § 368(a)(1)(A)-type reorganization. Each outstanding common share of [redacted] was converted into one share of [redacted] Each outstanding common share of [redacted] was converted into [redacted] shares of [redacted]. The consolidation was completed in [redacted].

As part of the consolidation, the taxpayer incurred expenses for financial advice, legal advice, investor relations, communication support, in-house personnel, internal labor and overhead. For the tax years [redacted] and [redacted], [redacted] deducted these costs for tax purposes. It asserts that the deduction is proper because the expenditures constitute business expansion costs.

DISCUSSION

1. In General, Merger or Consolidation Costs Are Capitalized and Added to the Basis of the Stock Acquired.

Capitalization pursuant to I.R.C. § 263 takes precedence over a current deduction

---

[1] In their promotional materials, the reorganization is called a merger. From the information provided, it is more accurately described as a consolidation. In a merger, one of the corporations being merged survives. In a consolidation two or more corporations unite to form a new corporation and the original corporations cease to exist. The consolidated corporation acquires the assets of the former corporations, assumes their liabilities and issues its shares for the shares of the former corporations.

[2] In [redacted] was the parent corporation of [redacted] In [redacted], [redacted] became the parent corporation of [redacted]. The audit plan for the tax years [redacted] through [redacted] describes the taxpayer as [redacted].

pursuant to I.R.C. § 162. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). Expenses incurred in connection with the reorganization of a business are generally nondeductible capital expenditures. Id. at 89-90.

Indicia of a capital expenditure are (1) the expense leads to the creation of a "separate and distinct additional asset" and (2) the expense creates a significant long-term future benefit. INDOPCO, 503 U.S. at 87. It may be sufficient that only one of these indicia be present for a transaction to be deemed capital. Id. At the same time, the mere presence of one of these indicia does not necessitate a finding in all situations that an expenditure be capitalized. Wells Fargo & Co. v. Commissioner, No. 99-3307, 2000 U.S. App. LEXIS 22201 at * 25 (8th Cir. Aug. 29, 2000), rev'g Norwest Corp. v. Commissioner, 112 T.C. 89 (1999). The nature of the transaction, rather than the taxpayer's primary purpose in engaging in the transaction, is determinative. Woodward v. Commissioner, 397 U.S. 572, 577-78 (1970).

The consolidation of [redacted] and [redacted], by its nature, is a capital transaction. The transaction created a new entity, [redacted]. So, it meets the "separate and distinct additional asset" definition of capital. It also provided a long-term benefit to [redacted] by, for example, expanding the reach of its business and the amount of its resources.

The inquiry, however is not completed once it is determined that a capital transaction has taken place. The costs incurred must also have a sufficient connection with the capital transaction in order to be capitalized. General expenses incurred in order to determine whether to enter a new business and which business to enter, in contrast to expenses incurred in an attempt to acquire a specific business, are deductible, depending upon the facts and circumstances. Rev. Rul. 99-23, 1999-20 C.B. 3. In such a situation, the expenditures may be too general or attenuated to be considered incurred in connection with a particular acquisition or reorganization.

For example, in Wells Fargo, 2000 U.S. App. LEXIS 22201 at *42-45, the Eighth Circuit Court of Appeals determined the proper tax treatment of legal fees paid in connection with, but prior to the completion of, a merger. Relying on Revenue Ruling 99-23, the court held that the portion of the fees incurred after the date the parties entered into the "Agreement and Plan of Reorganization" were capitalized. Those fees incurred prior to this date, however, the court determined to be deductible investigatory expenditures. The court explicitly stated, however, that the date used in Wells Fargo is not to be construed as a bright line rule. Rather, each case must be evaluated independently.

The court in Wells Fargo, 2000 U.S. App. LEXIS 22201 at *33-42, also determined that the salaries paid to corporate officers, where the corporate officers assisted in facilitating a reorganization as part of their normal duties, was a deductible expense. In Wells Fargo at *40-41, the officers had always received salaries, even before the acquisition became a possibility. There was no increase in their salaries attributable to the acquisition, and they would have been paid the salaries whether or not the acquisition took place. The salary expense was only

indirectly related to the acquisition. It was, however, directly related to the employment relationship between the taxpayer and its officers. Using the "origin of the claim" doctrine and also in reliance on the Service's position as stated in various TAM and PLR, the court held that the salary expenses were deductible. Wells Fargo at *34-37. In contrast, in a situation where the activities of the employee are directly related to a capital transaction, such as where an individual was hired specifically to facilitate a transaction, the salary would likely be capitalized. Wells Fargo at *39-40. Again, each case must be evaluated independently.

[redacted], [redacted]'s costs incurred in effectuating the consolidation between [redacted] and [redacted], [redacted] included costs for financial advice, legal advice, investor relations, communication support, in-house personnel, internal labor and overhead. The facts provided here are not sufficiently specific to determine if any of the expenses [redacted] incurred are deductible. In many instances, such types of expenses are capitalized. See e.g. American Stores Co. v. Commissioner, 114 T.C. 27 (2000) (expenses incurred to defend against a State's antitrust suit were capital because the antitrust suit arose out of the taxpayer's acquisition of another corporation); Victory Markets v. Commissioner, 99 T.C. 648 (1992) (expenses for professional services incurred incident to a takeover that is not hostile are capitalized); Ellis Banking Corp. v. Commissioner, 688 F.2d 1376 (11th Cir. 1982) aff'g. in part and remanding in part on an issue not relevant herein T.C. Memo 1981-123 (expenses for office supplies, filing fees, travel and accounting services incurred in connection with the target's books and records are nondeductible expenditures).

In this case, if the taxpayer can show that certain of the expenses were in the nature of general research or other investigation and/or are not sufficiently related to the consolidation, such expenses may be deductible. Additional information should be sought as to the type and timing of the expenditures in relation to the timing of agreements to enter into the consolidation. Also, additional information is needed regarding the types of services performed by in-house personnel in relation to the consolation and in comparison with their ordinary duties.

2. [redacted]s Assertion That the Expenses Are Deductible Because They Were Incurred Incident to the Expansion of an Existing Business Is Not Supported by the Facts Provided.

[redacted] asserts that its expenses were incurred in connection with the expansion of an existing business and are therefore deductible. The taxpayer has not elaborated on this argument.[3]

---

[3] Your request for advice included a discussion of organizational expenditures pursuant to I.R.C. § 248. As you determined, the expenses at issue here do not qualify for treatment as organization expenditures. This is due in part because, pursuant to Treas. Reg. § 1.248-1(b)(4), expenditures connected with the reorganization of a corporation, unless directly incident to the creation of a corporation do not qualify and a timely election is required to be attached to the taxpayer's return. Treas. Reg. § 1.248-1(c). Here, a new corporation was formed via a statutory

In FMR Corp. v. Commissioner, 110 T.C. 402 (1998), a post-INDOPCO case, the taxpayer similarly argued that its expenses were deductible because they were incurred as part of the expansion of an existing business. In addition, it argued that the legislative history of I.R.C. § 195 supports its position that the expenditures at issue did not create the "type" of future benefit that must be capitalized.

In FMR Corp, 110 T.C. 402, a taxpayer created and provided services to mutual funds, which it subsequently owned and operated. Each mutual fund was held within a trust but was treated as a separate company. The taxpayer incurred development and registration costs in the creation of each of the funds. It argued that because the costs incurred did not relate to its capital structure, but were incurred solely to maintain and promote its investment management business, they should not be capitalized. Id. at 423. The court held that "rather than attempting to assign the expenditures to a specific classification, such as expansion costs, we believe that the more important question is whether the expenditures in issue provide a significant future benefit to petitioner." Id. at 427.

The taxpayer in FMR Corp., 110 T.C. at 427, argued that by enacting I.R.C. § 195 Congress explicitly recognized the current deductibility of the costs of expanding an existing trade or business. In support of its argument, the taxpayer cited NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982). In that case, the Fourth Circuit Court of Appeals determined that:

> Congress is...under the impression that expenditures for market studies and feasibility studies, as at issue here, are fully deductible if incurred by an existing business undergoing expansion. An interpretation by us to the contrary would render section 195 meaningless for it would obliterate the reference point in the statute – "the expansion of an existing trade or business." FMR Corp. 110 T.C. at 429 (quoting NCNB Corp., 684 F.2d at 291).

The Tax Court, however disagreed. In FMR Corp., 110 T.C. at 428-29, it held that I.R.C. § 195 does not require that every expenditure incurred in any business expansion be currently deductible. Instead, as described in Revenue Ruling 99-23, I.R.C. § 195 merely removes the "trade or business" requirement from the I.R.C. § 162 requirements of deductibility. The remaining requirements - ordinary, necessary, paid or incurred during the taxable year - must still be met. I.R.C. § 162(a). According to Revenue Ruling 99-23, the purpose of I.R.C. § 195 is to facilitate the creation of new businesses by allowing a new business to deduct expenditures which took place before the business was "doing business" not to change the types of expenditures which are deductible. Rev. Rul. 99-23.

The proper test to apply is not whether the purpose was to expand the taxpayer's business

---

consolidation. While it is possible that certain expenses incurred in the creation of the new corporation might arguably qualify for I.R.C. § 248 treatment, no indication exists that a timely election was made.

but whether a separate and distinct asset or a substantial long-term benefit was created. The timing of an expense is not determinative except to the extent that timing is indicative of whether or not an expense is sufficiently connected with a capital transaction so as to be capitalized as part of that transaction. Similarly, general expenditures are probably not sufficiently connected with a capital transaction so as to be capitalized as part of that transaction. Salaries paid to employees who happen to facilitate a capital transaction also may be too indirect to be capitalized as part of the transaction. Instead, they may be more directly an ordinary and necessary compensation expenditure and therefore deductible. [redacted] has provided insufficient information to determine whether any of their expenditures are deductible.

If you have any questions, please contact Yvonne M. Peters at (619) 557-6014.

GORDON L. GIDLUND
Assistant District Counsel

By: _____
YVONNE M. PETERS
Attorney