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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's TIN:

Taxable Years:

Conference of right held:

Taxpayer =

$u =

$v =

$w =

$x =

$y =

$z =

Acquirer =

Taxpayer ESOP =

Month 1 =

Date 1 =

Date 2 =

Target =

Business A =

236

Business B =

Business C =

Business D =

Asset =

Asset Groups =

State A =

ISSUES

(1) Is the $w special dividend paid to Taxpayer's restricted stock plan participants deductible as compensation under §§ 162 and 83(h) or should such amounts be capitalized as part of the reorganization?

(2) Is the $y dividend paid to Taxpayer's ESOP participants deductible under § 404(k) or should it be capitalized as part of the reorganization?

(3) Are the ADSs valued at $x issued by Acquirer and distributed to Taxpayer's employees following the spin-off deductible compensation under §§ 162 and 83(h)?

CONCLUSIONS

(1) Because the $w special dividend paid to the Taxpayer's Restricted Stock Plan participants did not constitute a capital expenditure, it was deductible as a compensation expense under the rules of § 83(h) and § 1.83-6.

(2) Because the $y dividend paid to the Taxpayer's ESOP participants did not constitute a capital expenditure, it was deductible pursuant to § 404(k).

(3) Because the $x in Acquirer ADSs that were issued to Taxpayer's employees following the spinoff did not constitute capital expenditures, they were deductible as compensation expenses under the rules of § 83(h) and § 1.83-6.

FACTS

In Month 1, pursuant to a plan of reorganization, Target created a new wholly owned subsidiary, Taxpayer and contributed

its existing Business A, Business B, Business C, and Business D to Taxpayer. All of the stock of Taxpayer was spun-off to Target's shareholders in a divisive reorganization under § 355, and Target was acquired by Acquirer in type B reorganization. Following the spinoff, Taxpayer immediately declared a special dividend of $u per share to all Taxpayer's shareholders. This special dividend of $v was paid on Date 1.

In connection with the spin-off, Taxpayer established the Taxpayer ESOP on Date 2. The Taxpayer ESOP is an ESOP as described in § 4975(e)(7). All participants in the ESOP maintained by Target who were to be employed by Taxpayer after the spin-off became participants in the Taxpayer ESOP. These participants received one share of Taxpayer stock in their Taxpayer ESOP accounts for each share of Target stock in their Target ESOP accounts, which were then canceled.

The special dividend was an integral part of the sale of Target to Acquirer. This was spelled out in the prospectus relating to the transaction. In addition, in testimony to the State A Taxpayer indicated that the dividend was an inducement to Target shareholders to approve the transaction. The dividend was paid to all shareholders, not just employees. Indeed, Taxpayer testified that "[m]anagement shareholders are essentially being treated like all other shareholders." However, the reorganization transaction was not dependent on the special dividend and would proceed regardless of whether the special dividend was actually paid. Indeed, at the time of the reorganization there was no legal obligation to pay the special dividend; Taxpayer had sole discretion to declare and pay such dividend.

The financial structure was that Acquirer paid cash to Target which was used to retire debt. Taxpayer then borrowed funds to pay the special dividend. At the time of the reorganization Taxpayer did not have sufficient funds to pay the special dividend and did not have definitive bank credit facilities to borrow funds to pay the dividend. A credit arrangement was obtained after the reorganization following extensive negotiations with the lender. Taxpayer then used the credit arrangement to pay the special dividend.

Taxpayer's decision to borrow $v was based in part on its concern that its level of debt, which was low in relation to the debt levels of Taxpayer's industry peers, might attract an unwanted takeover offer. Taxpayer also wished to maximize shareholder value in a manner that was consistent with its asset management strategy. This asset management strategy, which has been used very successfully by other Asset Groups, involved minimizing ownership of Asset real estate and obtaining new

management or franchise contracts instead. Since Taxpayer's Asset Groups would then need less capital to support the same level of profitability, they would have a higher return on equity and earnings per share, resulting in higher stock market valuations. To address its capitalization and shareholder commitment concerns, Taxpayer borrowed $v and then paid this amount to shareholders as a special dividend because, in accordance with its asset management strategy, it did not want to increase its capital investment. Taxpayer had sufficient earnings and profits by the end of the year for this amount to be treated as a dividend. In the business judgment of Taxpayer's management, the special dividend was essential to Taxpayer's maintenance of the business and operational discipline required to achieve its optimal financial results, and was also necessary to demonstrate its commitment to shareholders.

Of the special dividend, $y was paid in cash directly to participants in the employee stock ownership plan (ESOP) maintained by Taxpayer. This amount constitutes less than one-third of one percent of the total dividend, which was paid with respect to all shares. The ownership percentage of Taxpayer held by ESOP participants was unchanged after the dividend. There was no redemption of stock held by the ESOP, and the dividend was not used to repay an exempt loan (the ESOP was not leveraged).

The treatment of certain portions of the aggregate $v dividend is at issue. Taxpayer's Restricted Stock Plan participants received approximately $w on on their unvested restricted stock. Taxpayer deducted this amount under §§ 162 and 83(h). In addition, Taxpayer is seeking to deduct approximately $y paid as a dividend to Taxpayer's ESOP plan participants under § 404(k). Exam believes that these amounts should be capitalized as part of the cost of the reorganization.

LAW AND ANALYSIS

The issues in this request for technical advice are whether Taxpayer may deduct the amounts described above in Issues 1, 2, and 3 or whether those amounts must be capitalized under § 263. The field asserts that Taxpayer should capitalize the amounts at issue under § 263. In contrast, the Taxpayer believes that the amounts described in Issues 1 and 3 should be deducted currently under §§ 83 and 162 and the amounts described in Issue 2 should be deducted currently under § 404(k). For the reasons described below, we conclude that the amounts described in Issues 1,and 3 are deductible currently under §§ 83(h) and 162 and are not capitalizable under § 263. We further conclude that the amounts described in Issue 2 are deductible currently under § 404(k) and are not capitalizable under § 263.

I. Section 83 Compensation

Under § 83 of the Code, if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property, on the first day that the rights to the property are either transferable or not subject to a substantial risk of forfeiture, over the amount paid for the property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

Stated differently, property is not taxable under section 83 of the Code until it is transferred to and substantially vested in the service provider (or beneficiary thereof). Until the property becomes substantially vested, the transferor of the property is considered the owner of the property. Any income from the property received by the service provider (or beneficiary thereof) constitutes additional compensation to the service provider for the taxable year in which it is received. See § 1.83-1(a)(1). See also Revenue Procedure 80-11, 1980-1 C.B. 616, which applies these rules to dividends paid on substantially-nonvested stock.

Under § 83(h), the service recipient is allowed a compensation expense deduction, under § 162, in an amount equal to the amount included in the service provider's gross income under § 83(a). The deduction is allowed for the taxable year of the service recipient in which or with which ends the service provider's taxable year in which the amount is included in gross income.

However, no deduction is allowed under § 83(h) to the extent that the transfer of property constitutes a capital expenditure, an item of deferred expense, or an amount properly includible in the value of inventory items. In the case of a capital expenditure, for example, the basis of the property to which such capital expenditure relates is increased at the same time and to the same extent as any amount includible in the service provider's gross income in respect of such transfer. Thus, for example, no deduction is allowed to a corporation in respect of a transfer of its stock to a promoter upon its organization, notwithstanding that such promoter must include the value of the stock in gross income in accordance with the rules under § 83. See § 1.83-6(a)(4). The concepts contained in § 1.83-6(a)(4) apply to dividends paid with respect to substantially-nonvested § 83 stock, including dividends paid in the from of ADSs.

II. Capitalization

Sections 162 and 263 of the Code together with their related regulations provide the statutory and regulatory framework for analyzing severance payments. Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation. Section 263(a) provides that the cost of permanent improvements or betterments made to increase the value of any property or estate must be capitalized.

Section 161 of the Code clarifies the relationship between deductions allowable under § 162 and capital expenditures under § 263. Section 161 provides that the deductions allowed in Part VI, including § 162, are subject to the exceptions set forth in Part IX, including § 263. Thus, the capitalization rules of § 263 take precedence over the rules for deductions under § 162. See Commissioner v. Idaho Power Co., 418 U.S. 1 (1974); see also INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992).

In describing the interplay between § 162 and § 263, the Supreme Court noted in INDOPCO that deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. INDOPCO at 84. Further, expenditures that are required to be capitalized are not exhaustively enumerated in the Code. Id. The Code and regulations specifically enumerate compensation such as severance pay as a business expense that is deductible under § 162.

The treatment of compensation was not changed by INDOPCO. For example Rev. Rul. 94-77, 1994-2 C.B. 19, holds that INDOPCO did not affect the treatment of severance payments as business expenses that are generally deductible under § 162 and § 1.162-10. However, Rev. Rul. 94-77 does not address, and no inference is intended regarding, the federal income tax treatment of severance payments made as part of the acquisition of property (including a deemed acquisition of assets pursuant to § 338).

In this case, the field asserts that the special dividend was made as part of the acquisition of property. In particular, the field reasons that the dividend at issue was not incurred in the ordinary course of a trade or business; rather, its origin may be traced to the reorganization. The origin of the claim doctrine provides that the origin and character of a claim determine the deductibility of an expense. See Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); United States v. Gilmore, 372 U.S. 39 (1963). The characterization of costs depends upon the nature of the activities giving rise to the claim and does not depend on consequence or result. Gilmore, 372 U.S. at 47-48. See also

Keller Street Dev. Co. v. Commissioner, 688 F.2d 675 (9th Cir. 1982).

Courts have consistently held that costs incurred incident to a corporate reorganization, recapitalization or acquisition by another entity should be capitalized. See e.g., INDOPCO, supra, (legal, investment banking, and other fees incurred in effectuating an acquisition); Hilton Hotels Corp., supra (appraisal litigation expense occasioned by minority shareholders' objection to merger); Bilar Tool & Die v. Commissioner, 530 F.2d 708, 710 (6th Cir. 1976) (legal and accounting fees incurred in connection with a plan of reorganization); Vulcan Materials Co. v. United States, 446 F.2d 690 (5th Cir. 1971), cert. denied, 404 U.S. 942 (1971) (recapitalization and reorganization expenditures). The Service's position with respect to reorganization costs is consistent with judicial authority. See, e.g., Rev. Rul. 67-125, 1967-1 C.B. 31 (expenses incident to the alteration of the capital structure of a corporation are capitalized). The field reasons that the special dividend is nothing more than additional purchase price paid as part of the reorganization. Under this reasoning, the possibility that the special dividend might never be paid is irrelevant to determining how it is characterized.

In contrast, Taxpayer asserts that the special dividend does not have its origin in the reorganization. It argues that reorganization transaction was not dependent on the special dividend and would proceed regardless of whether the special dividend was actually paid. Taxpayer further reasons that, at the time of the reorganization, there was no legal obligation to pay the special dividend. It notes that it had sole discretion to declare and pay such dividend. Taxpayer argues that these facts show that the reorganization was not the origin of the special dividend. In support of its position, Taxpayer cites a series of cases which have allowed a current deduction for severance payments where the liability to make such payments arises after the acquisition. See Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff'd, 333 F.2d 653 (2d Cir. 1964); Minneapolis & St. Louis Railway Co. v. United States, 57-2 USTC ¶ 9964 (D. Minn. 1957), aff'd, 260 F.2d 663 (8th Cir. 1958).

Some support for the field's position is found in Great Lakes Pipe Line Co. v. United States, 352 F.Supp. 1159 (W.D. Mo. 1973), aff'd in an unpublished order (7th Cir. 1974). In Great Lakes, the taxpayer entered into employment contracts with key employees after it announced that it was looking for a buyer for its business. The purpose of the contracts was to prevent key employees from leaving the company in mass, which might jeopardize the sale. The contracts provided that employees would continue to be paid after the sale even if the buyer did not

require their services. The taxpayer then paid the buyer $650,000 in satisfaction of the amount the buyer would have to pay the former employees under these agreements. The taxpayer deducted this amount under § 162(a). The court held that the buyer's payment was not deductible currently but rather represented an adjustment to the purchase price received by the taxpayer. See also Rev. Rul. 73-146, 1973-1 C.B. 61 (new obligations generated by a reorganization which represent a cost of the reorganization require capitalization).

Great Lakes is distinguishable from Taxpayer's situation in that the payment in that case was between the parties to the sales contract. In this case, the special dividend was paid to all shareholders following the reorganization and not to the acquiring company. Further, the reorganization was not contingent on payment of the special dividend. These facts also distinguish the instant case from Rev. Rul. 73-580, 1973-2 C.B. 86, which requires capitalization of amounts paid by a corporation to its employees for services performed with respect to mergers and acquisitions.

Although it is clear that the special dividend was coincidental to the reorganization, the special dividend does not have its origin in the reorganization. Indeed, the reorganization was not dependent on the special dividend and would have proceeded regardless of whether the special dividend was actually paid. At the time of the reorganization there was no legal obligation to pay the special dividend; Taxpayer had sole discretion to declare and pay such dividend. Rather, the special dividend originates in Taxpayer's asset management strategy -- a strategy which has been used very successfully by other Asset Groups. Accordingly, the special dividend is not capitalizable under § 263 as part of the cost of the reorganization.

III. Section 404(k) Deduction

With respect to Issue 2, § 404(k), as amended by the Tax Reform Act of 1986 ("TRA '86") and as in effect for the taxable year in question, generally permits a corporation to deduct the amount of any applicable dividend paid in cash by the corporation during the taxable year with respect to employer securities which are held on the record date for such dividend by an employee stock ownership plan which is maintained by the corporation paying the dividend or any other member of the same controlled group of corporations. An applicable dividend is defined, in part, as a dividend which is paid in cash to plan participants or their beneficiaries.

Section 404(k)(5)(A) states that the Secretary may disallow

the deduction for any dividend if the Secretary determines that such dividend constitutes, in substance, an evasion of taxation. The TRA '86 Conference Report, No.99-841, 1986-3 C.B. Vol.4, 11-852, states in part that the conferees intend that this deduction is to be allowed only with respect to reasonable dividends.

In the present case, Taxpayer, which maintains the Taxpayer ESOP, paid approximately $y in cash as a dividend to plan participants with respect to employer securities held by the Taxpayer ESOP. This amount was part of a $v dividend which was paid to all shareholders with borrowed funds. Taxpayer determined that its business interests were best served by incurring debt so that its capitalization would be similar to that of its industry peers, and that using the proceeds to pay a special dividend was the only use that would be consistent with its asset management strategy and its commitment to shareholders. The amount paid directly to the Taxpayer's ESOP participants was less than one-third of one percent of the total dividend. The total dividend was not used to repay an exempt loan. There was no stock redemption, nor was there any reduction in the percentage of the company owned by the Taxpayer ESOP participants. Under these facts and circumstances, the special dividend is reasonable and does not constitute an evasion of taxation.

Therefore, we conclude with respect to Issue 2 that the $y dividend paid to the Taxpayer's ESOP participants is deductible pursuant to § 404(k). This conclusion is based on the assumption that the Taxpayer's ESOP was qualified under § 401(a) and § 409 at the time that the dividend was paid. This conclusion is also based on the assumption that the special dividend is a dividend within the meaning of § 316.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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