The Costs of Failure: Learning from Your Mistakes

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Learning from your mistakes is supposed to be a good thing. We all try to do it. Yet, from a tax perspective, learning from your mistakes in acquisition negotiations may end up having a tax cost. At least that’s how the IRS may try to spin it.

In TAM 200512021 [Dec. 29, 2004], the IRS keeps alive (arguably on life support) the position it advocated 70 years ago, in Portland Furniture Manufacturing Co. [30 BTA 878, Dec. 8592 (1934)]. In Portland, the IRS argued that costs of a failed merger were not deductible in the year the taxpayer incurred them, but were deductible in the following year when the taxpayer completed the merger. The IRS argued that since the taxpayer gained certain knowledge and received a benefit from the failed merger, then the costs of that failed merger should be capitalized. Fortunately, the court disagreed, determining that the costs of the failed merger were deductible in the year incurred because the costs were “separate and distinct” from the subsequent successful merger.

Old theories die hard, or at least that’s how it now seems. Recently, the IRS determined that termination fees paid to end a proposed merger are capital expenditures. The taxpayer in TAM 200512021 entered into a Merger Agreement, which contained termination provisions allowing the taxpayer to opt out of the proposed merger for a fee, with a prospective Seller. During negotiations with Seller, the taxpayer invested costs into a different business proposal (“Superior Proposal”), which it subsequently accepted. After deciding to accept the Superior Proposal, the taxpayer terminated its agreement with Seller and paid the termination fee.

The taxpayer deducted this termination fee and listed the deduction on Form 8275, stating the deduction was claimed under Code Sec. 162 as a buyout fee. The IRS disallowed the deduction, stating

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the termination fee was a nondeductible capital expenditure related to the taxpayer’s subsequent Superior Proposal transaction. The taxpayer then requested technical advice from the IRS.

**The Times They Are a Changin’**

In March of 2005, the IRS responded with TAM 200512021, in which the IRS determined that “[b]ecause [the] taxpayer’s payment of the termination fee is directly related to the [Superior Proposal transaction], and because the [Superior Proposal transaction] confers significant future benefits to [the] taxpayer, the termination fee is a capital expenditure.” The IRS focuses primarily on the relationship between “future benefits” and current costs. In a sort of inverted approach, the IRS supported its decision with several cases in which the costs of failed mergers were allowed to be deducted, but had no relevant effect on a subsequent merger. [See Federated Department Stores, Inc., DC Ohio, 94-2 USTC ¶50,430, 171 BR 603, Doc 94-7323, 94 TNT 153-15 (1994); A.E. Staley Manufacturing Co., CA-7, 97-2 USTC ¶50,521, 119 F3d 482 (1997); and Metrocorp, Inc., 116 TC 211, Dec. 54,308 (2001).] The taxpayers in those cases deducted costs paid to hold off hostile takeovers.

More than a few M&A Tax Report readers may be scratching their heads over these cases being cited by the IRS. After all, these were good cases for taxpayers. In a leap of logic, the IRS suggests the rationale that taxpayers who want to stay with the status quo do not incur a future benefit, and thus the costs they incur to remain the same are deductible. While it is arguable that costs to stay the course and costs to change or alter a current business practice still affect the future of a company, it seems the IRS’s focus is on some new benefit to the taxpayers’ current business practice. Well, kind of.

While TAM 200512021 appears to be in line with the infamous INDOPCO decision, it is arguable that the IRS is actually increasing its scope. The TAM points out that in INDOPCO [SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039 (1992)], the Supreme Court determined that “the presence of an ensuing benefit that may have some future aspect is not controlling” to determine whether an expense represents a capital expenditure [also see Lincoln Savings & Loan Ass’n, SCt, 71-1 USTC ¶9476, 403 US 345, 354, 91 SCt 1893 (1971)]. The Court concluded that the mere presence of an incidental future benefit may not warrant capitalization but emphasized that benefits beyond the year in which the expenditure is incurred are important.

INDOPCO also held that expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are capital expenditures. The Supreme Court considered whether costs incurred by a taxpayer in a reverse subsidiary merger were nondeductible capital expenditures. The Court found that the merger produced “significant benefits to [the taxpayer] that extended beyond the tax year in question,” and therefore, the expenditures were not deductible. The Court pointed out several facts it used to make its determination, including (1) the extent a
taxpayer would benefit from the acquisition of the target’s resources, (2) the level of synergy that might exist with the acquiring target corporation, and (3) whether the taxpayer is allowed to reduce its number of authorized shares to ease administrative burdens.

There are situations in which termination payments made to acquire a new benefit may require capitalization, even if the termination payments are not closely connected to that new benefit. In 12701 Shaker Boulevard Co. [36 TC 255, Dec. 24,825 (1961)], the court allowed a taxpayer to deduct a prepayment penalty incurred in paying off existing debt in order to acquire a new loan from a lender. However, if cancellation payments are closely linked to the acquisition of a “long-term benefit,” courts will treat the payment as the payment of a capital expenditure. In U.S. Bancorp [111 TC 231, Dec. 52,871 (1998)], a taxpayer was required to capitalize a lease cancellation payment made in order to enter into a more favorable lease with the same lessor. [See also Basin Electric Power Cooperative, 87 TCM 1266, Dec. 55,627(M), TC Memo. 2004-109 (2004).]

I Like You Better

In TAM 200512021, the taxpayer did terminate its Merger Agreement with Seller to be able to accept the Superior Proposal. However, the taxpayer was not fully engaged in a business deal that it later cancelled. In both Shaker Boulevard and U.S. Bancorp, the taxpayers were already engaged in a business deal when it incurred costs to withdraw from those deals. In TAM 200512021, the taxpayer was paying a fee to avoid a certain transaction and not enter into that transaction at all. This is more akin to losing a security deposit rather than paying fees to cancel an existing business transaction.

TAM 200512021 added that “[t]here is nothing in the record suggesting that [the] taxpayer would have suffered any economic detriment had it completed the merger with [its target] or that [the] taxpayer would have extricated itself from the agreement if there had been no [subsequent] proposal.” This appears to contradict the reason the taxpayer began searching for additional proposals. The TAM explained that one of the “significant” shareholders expressed concern that the original merger was not in the “best interests” of the shareholders, and requested and received permission to develop a subsequent proposal, which led to the Superior Proposal.

The IRS also concluded that the termination fee was paid to acquire a benefit that would not have otherwise been available to the taxpayer. However, the initial merger was not fully developed, and the taxpayer was constantly searching out new business transactions. Therefore, it’s hard to swallow the IRS’s conclusion that the termination fee was paid for a benefit that was not otherwise available, merely because one deal sort of led to another. After all, any business engaged in a single industry may entertain multiple (yet similar) deals during a given time period. Is the next step to argue that all transactions are somehow related?

A Stitch in Time, or Is Patience a Virtue?

Reg. §1.263(a)-4 and -5 govern which transaction costs paid after December 31, 2003, might be currently deductible, and which have to be capitalized. More specifically, termination fees involved in TAM 200512021 fall under Reg. §1.263(a)-5(c)(8).

Termination payments under this regulation are treated as nondeductible costs paid to facilitate a second transaction, only if the transactions are “mutually exclusive.” A “mutually exclusive” event is when an occurrence of any one event automatically implies the nonoccurrence of the remaining event. Two mutually exclusive events cannot both occur.

In TAM 9402004 [Sept. 10, 1993], three brothers who controlled 72.5 percent of a corporation decided to sell off their interest in that corporation. The corporation retained an advisor who developed a list of prospective
buyers. Two of the three brothers played major roles in the due diligence process. The corporation later deducted six-sevenths of its financial, legal, accounting, internal payroll and other costs of its eventual sale. The taxpayer argued that it abandoned its merger transactions with the other potential buyers when it was finally acquired. The taxpayer said this entitled it to deduct its expenses related to these “failed” transactions. The IRS disagreed. TAM 9402044 stated that a taxpayer engaging in a series of transactions who later abandons one of those transactions, is allowed a loss, even if the taxpayer later proceeds with a similar transaction.

The IRS cited several cases that allowed a deduction for the abandonment of a “separate and distinct” transaction even if subsequent or alternative independent transactions were pursued. The IRS decided that if the proposals are alternatives, only one of which can be completed, no abandonment loss is proper unless the entire transaction is abandoned. Abandonment losses are not allowed for proposals that are “mutually exclusive” alternative methods of reaching a desired financial position. See Tobacco Products Export Corp., 18 TC 1100, 1104, Dec. 20,130 (1952); and Doernbecher Manufacturing Co., 30 BTA 973, Dec. 8606 (1934), acq., XIII-2 CB 6, aff'd, CA-9, 36-1 USTC ¶9030, 80 F2d 573 (1935).

Note. A taxpayer may want to document the abandonment of any of its transactions. The IRS has a clear motive to argue for capitalization of costs, and therefore taxpayers have an incentive to substantiate the abandonment of any transactions to support deducting costs associated with these abandoned transaction.

However, Reg. §1.263(a)-5(e)(8) provides that employee compensation, which includes guaranteed payments to partners and annual compensation paid to corporate directors, is not included in the amount that is paid to facilitate a mutually exclusive transaction. In addition, de minimis costs up to an aggregate of $5,000 may be expensed. Furthermore, the regulation established a cutoff date before which expenses that facilitate the transaction need not be capitalized. The date is the earlier of:

(i) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or

(ii) The date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer’s board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer’s board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) the date determined under this paragraph (e)(1)(ii) is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.

The regulations do cut out costs that are “inherently facilitative amounts,” such as appraisals, fairness opinions related to the transaction, costs of structuring the transaction (which includes negotiating its structure and obtaining tax advice), and the costs of preparing and reviewing the documents that support the transaction. Therefore, the nature of the costs should be analyzed, based on all the facts and circumstances of the transaction to determine whether those costs facilitated a deal.

Conclusion

Virtually any business engaging in corporate transactions faces the issue whether costs are deductible or must be capitalized. In some instances, it is clear that expenses that directly benefit the future get capitalized. However, costs that only produce a general or incidental benefit do not necessarily require capitalization. At the end of the day, it appears that costs that “lead to” some benefit might require capitalization. Confusing, isn’t it?

This amorphous linkage is obviously subject to different interpretations, since the facts can perhaps be spun in one of several different ways. In weighing this linkage, bear in mind that timing is also key.
If in TAM 200512021 the Superior Proposal came along two years after the “significant” shareholder recommends that the taxpayer terminate the Merger Agreement, would the IRS claim that the costs incurred two years prior require capitalization? I doubt it. So in this instance, a “stitch in time” might actually cost a deduction, whereas patience might mean more than a virtue. It might also mean a deduction.

Taxpayers will be faced with many positions that are different than the scenario in TAM 200512021. The facts are going to be critical. Taxpayers should be aware of the Treasury Regulations’ requirements and the fact that the IRS is seeking to expand the scope of INDOPCO.

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Book Review: Daniel W. Hindert, Joseph J. Dehner and Patrick J. Hindert’s STRUCTURED SETTLEMENTS AND PERIODIC PAYMENT JUDGMENTS

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Structured settlements are not new. At its root, a structured settlement is simply a settlement that calls for periodic payments made over time. In a structured settlement of a personal injury action, which is where structures began, the plaintiff generally receives payments monthly or annually, instead of receiving payment in one lump sum. There are tax as well as nontax advantages. The use of periodic payments in settlements has been gaining increased popularity since the 1970s.

In fact, they are now an established part of the practice of many personal injury lawyers. Similarly, structured settlements are becoming an increasing part of the work of defense lawyers. Tax lawyers often are asked to address the tax consequences of a structure.

In that regard, a copy of STRUCTURED SETTLEMENTS AND PERIODIC PAYMENT JUDGMENTS, written by Daniel W. Hindert, Joseph J. Dehner and Patrick J. Hindert and published by Law Journal Press, recently landed on my desk. Originally published in 1986, it is a looseleaf tome that the authors have updated frequently ever since.

Lay of the Land

Falling open at nearly the center, the authors divide the book into two parts. The first half of the book comprises 15 chapters. The first two chapters provide a discussion of the history of structured settlements and a high-level review of the taxation of damage awards received by claimants. The more interesting chapters of the book follow. These chapters address issues related to financing alternatives, the role of the plaintiff and defense counsel, case preparation, negotiation and closing and topics such as workers compensation and special needs trust. A major topic discussed throughout the book is the use of Code Sec. 468B qualified settlement trusts.

Later in the book, the authors discuss the specifics of factoring transactions, the Uniform Periodic Payment Settlements Act and a miscellany of state statutes, as well as different aspects of annuity testimony and the impact of social security. Many of these topics are frequently overlooked by practitioners and to my knowledge are not discussed in such detail elsewhere.

Cleaning Things up

The authors provide an authoritative and practical approach to the subject, highlighting and alerting the reader to a number of traps for the unwary. A chapter I found especially interesting relates to environmental claims, a topic recently discussed in the M&A TAX REPORT. The authors discuss aspects of environmental personal injury actions, superfund cases and using a Code Sec. 468B qualified settlement fund in connection with environmental settlements.

Of specific interest is the authors’ note that a Code Sec. 468B designated settlement fund must be established for the principal purpose of “resolving and satisfying” present and future claims. [Code Sec. 468B(d)(2)(D).] A Code Sec. 468B trust may not satisfy the “resolve and