MORE ACQUISITION EXPENSES TO WATCH OUT FOR

By Robert W. Wood • San Francisco

We at *The M&A Tax Report* talk a lot (and some would say preach too much) about the rigors of the IRS's view of INDOPCO, with its "capitalize everything" mentality. For our most recent coverage of this pervasive issue, see Muntean and Wood, "Tax Court Bloats *INDOPCO* in *Norwest Corp. v. Commissioner*, Vol. 7, No. 10, *M&A Tax Report* (May 1999), p. 1.

Notwithstanding our admitted obsession with *INDOPCO*, there is a less well-publicized schism that arises not from the dichotomy between ordinary and necessary business expense treatment vs. capitalization, but rather, from whether the expense is amortizable as a start-up expense under Section 195. The recent release of Rev. Rul. 99-23, 1999 TNT 84-39, Tax Analysts Doc. No. 1999-15962 (May 3, 1999), involves three situations that are worth rubbing your eyes over.

Case 1: The Investment Banker

The first scenario discussed in Rev. Rul. 99-23 involves a corporation's hiring of an investment banker in April 1998 to evaluate the possibility of acquiring an unrelated trade or business. The investment banker did his investigating of several industries, but the focus of the inquiry was quickly narrowed to one industry. After evaluating several businesses within that industry, the investment banker then commissioned an appraisal of the assets of one business, as well as an in-depth review of its books and records. The idea of these exercises was to establish a fair purchase price for this particular company.

On November 1 of the same year, the taxpayer corporation closed a purchase of all of the target's assets. Before executing the acquisition agreement, the corporation did not prepare or submit documents indicating its intent to purchase the target. (This was a no-nonsense buyer.)

Applying the rules of Section 195 to this situation, the IRS concludes that the costs incurred to conduct industry research and to evaluate publicly available financial information could be amortized under Section 195. However, the costs relating to the appraisals of the target's assets and the review of books and records could not.

Case 2: The Law Firm

In the second case considered in Rev. Rul. 99-23, the corporation began searching for a trade or business to acquire in May 1998. Assuming that it would find a suitable target, it hired an investment banker to evaluate three potential businesses. Also, the company hired a law firm to begin drafting regulatory approval documents, even though a specific target company had not yet been identified. Eventually, the taxpayer corporation decided to purchase another company's assets, and an acquisition agreement between the companies was signed on December 1, 1998.

Here, the Service said that the costs incurred to evaluate potential businesses were eligible for amortization under Section 195 to the extent they related to the decision "whether" the business should be acquired and "which" business should be acquired. On the other hand, the costs incurred to draft regulatory approval documents before the acquiring corporation had actually decided to purchase the target would not be amortizable under Section 195. Even if those activities occurred while the acquiring corporation was engaged in a general search for a business, in fact, the costs associated with them would be considered as incurred to facilitate an acquisition. Thus, they would not qualify for the amortization of Section 195 and would instead have to be capitalized.

Case 3: The Accounting Firm

In the third case, the acquiring company hired both a law firm and an accounting firm to assist in the potential acquisition of a target. Both firms were to render services that were labeled as "preliminary due diligence," although the services were described broadly enough to include researching the target's industry and analyzing the target's financial projections for 1998 and 1999.

At the acquiring company's request, in September of 1999, the law firm submitted a letter of intent to the target, stating that a binding commitment to proceed with the proposed transaction would result only when the parties executed an acquisition agreement. Both firms continued to provide the due diligence services after this letter. The due diligence included review of such items as insurance policies, employment agreements, lease agreements, and the like. Of course, the law and accounting firms also did an in-depth review of the books and records of the target, and the law firm prepared an acquisition agreement.

Here, the IRS concluded that the costs related to what it called the "preliminary due diligence" services that were provided before September 1998 were eligible for amortization under Section 195. This period before September 1998 was the period

(continued on page 6)

MORE ACQUISITION EXPENSES TO WATCH OUT FOR

(continued from page 5)

before which the corporation had decided to acquire the target and had instructed the law firm to prepare and submit a letter of intent. In other words, the "preliminary" due diligence costs were only those costs incurred *up to* the line (drawn in the sand) at which a decision was made. That decision cut off the availability of any further costs that could be amortized under Section 195.

The due diligence costs (as opposed to the costs of the "preliminary due diligence"), however, were ruled by the Service *not* to qualify for amortization under Section 195. The ruling concludes that the due diligence services provided after that time were not amortizable, because they related to the attempt to acquire the target. The Service thus concluded that the costs incurred to review the target's internal documents, books, and records—and certainly the costs to draft the acquisition agreements—were not eligible for amortization under Section 195.

What Works and What Doesn't?

Looking at all three situations together, the IRS concluded that each situation involved active targets that were unrelated trades or businesses. Each acquisition involved an acquiring company that was an accrual method and calendar year taxpayer. Each one did complete its acquisition in 1998, and each one timely filed an election on its 1998 return to amortize its start-up expenditures over a period of five years under Section 195(b). The IRS even noted that all three acquisition agreements had customary closing conditions.

The only expenses incurred in the course of a general search for (or preliminary investigation of) a business were the ones that the Service singled out. Under Section 195, "investigatory expenditures incurred in order to determine whether to enter into a transaction and which transaction to enter" are amortizable under Section 195. Once a taxpayer has made the determination "whether and which" business to acquire, all costs incurred in an attempt to acquire the business must be capitalized.

To determine the proper categories for the expenses, the IRS said that one had to apply (here it goes) an analysis of all facts and circumstances surrounding the transaction. (Boy, that will be easy!) The parties here characterized the costs and the temporal point in time at which the costs were incurred. The mere fact that the parties viewed the costs in a particular way, however, would not necessarily determine the nature of the costs, according to the ruling.

Deductible (Best), 195 (Next Best) and *INDOPCO* (Worst)?

Here at the *M&A Tax Report*, we have long said that the dividing line between ordinary and necessary business expenses on the one hand and costs that must be capitalized as part of an acquisition on the other hand is not a precise one. Far from precise, it can be just plain fuzzy. The case law has encouraged a kind of bifurcation of fees and services, and it has now come to be fairly commonplace.

However, many of us may not have thought for a while about one of the fundamental points applicable to start-up costs and their tax treatment as embodied in Section 195. The 60-month amortization contained in Section 195 is certainly not a fabulous bonanza the way an ordinary business expense deduction would be. At the same time, Section 195 treatment is also not the terrible deal that *INDOPCO* can impose. It can represent a kind of a middle ground. Some expenses may not be worth fighting over (at least not too steadfastly) if five-year amortization under Section 195 is available.

Rev. Rul. 99-23 goes through three situations that most advisors will have to admit sound awfully familiar. The factual distinctions between the three situations are, as one can readily see, not terribly dramatic. The results of the acquisition (from a business perspective) were presumably all the same. Yet, the tax consequences of the particular transaction costs considered in each situation (at least according to the way the Service considered it) were quite different.

Conclusion

One real question about all this is exactly how significant the Section 195 costs would turn out to be in a given case. Without numbers and an example, it may be difficult to get too excited about amortization over five years versus some other treatment, but the costs in these situations (and indeed, in any one of the three cases posited by the Service in Rev. Rul. 99-23) may be quite large.

Faced with large costs, having an item go from the deductible column to 60-month amortization may even rise to the level—a moniker that we've used in connection with *INDOPCO* treatment for some time—of draconian. Still, if the alternative is capitalization over a much longer period, or an (even more disagreeable) addition to basis, Section 195 amortization may look fairly appealing.