Divide and Conquer?

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No, this is not an article about spin-offs, though here at the M&A Tax Report, we admit that we like that topic. Instead, this article is about yet another iteration of the prevalence of *INDOPCO* in our consciousness. If a company embarks on investigation of various proposed transactions, it is important to segregate, to parse, to winnow.

If you do not, you may end up capitalizing it all. That is the lesson, or perhaps the theme, of Technical Advice Memorandum 200749013 (Aug. 14, 2007).

Scuttling Deals

The issue in this TAM was whether costs incurred by the taxpayer in investigating and pursuing potential restructuring deals that were *not consummated* were deductible as business expenses under Code Sec. 162, could be deducted as losses under Code Sec. 165, or rather (uggh!) were nondeductible capital expenditures under Code Sec. 263. The ruling has somewhat predictable facts, a taxpayer with messy restructuring plans. The IRS field personnel apparently said, "None of it is deductible," and the taxpayer said essentially the opposite. The TAM laboriously describes each of the transactions, but a fairly simple explanation is enough to get the gist of what happened here.

Just the Facts

The company was stagnant and, faced with this lack of growth, explored strategic restructuring alternatives to focus on core activities. The company hired a consultant and investigated the following:

- Maintaining the status quo
- A leveraged recapitalization, or a full recapitalization with a spin-off of lesser business divisions
- A divestiture of the lesser divisions (This third divestiture option contained various subparts, including a targeted stock offering, or an IPO with a split-off or spin-off.)

The three proposals were presented to the board by the consultant. The board voted to eliminate the status quo choice, and to eliminate the leveraged or full recapitalization. Thus, as of the board vote, only the divestiture proposal (with its subparts of a targeted stock offering or an IPO, with a split-off or spin-off) remained under consideration.

Time After Time

The next relevant date in the timeline was a board meeting where the company's board eliminated consideration of a spin-off or targeted stock offering. That left only an IPO with a split-off. The same day, the board approved a reorganization to form two companies, including a subsidiary that would consist of all of the lesser divisions.

Consequently, the taxpayer then contributed the assets and liabilities of these lesser divisions to a new subsidiary. Thereafter, the subsidiary registered for an IPO with the SEC. Finally, the taxpayer finalized its decision to divest the subsidiary through an IPO and split-off, and the IPO of the common stock of the subsidiary was completed.

The taxpayer then turned to a split-off, in which certain shareholders holding stock in the taxpayer would exchange their stock in the taxpayer for stock in the subsidiary. That was necessary because, after the IPO, the common stock of the subsidiary was owned both by the taxpayer parent and by unrelated public shareholders who purchased stock in the IPO. The subsidiary filed with the SEC concerning the contemplated split-off.

However, the taxpayer parent company later abandoned the split-off when it became apparent that a split-off of the subsidiary would not maximize shareholder value (there's that phrase again). Instead, the parent's board of directors approved a spin-off, and it was eventually completed.

Continuum or Separate Episodes?

There is good authority for the proposition that a taxpayer who investigates and pursues multiple separate transactions can deduct costs that are properly allocable to any abandoned transactions, once those transactions are in fact scuttled. See *Sibley, Lindsay & Curr Co.*, 15 TC 106, Dec. 17,788 (1950), *acq.* 1951-1 CB 3. Furthermore, if a taxpayer engages in a series of transactions, and only abandons *one* transaction, a loss is allowable even if the taxpayer later proceeds with a *similar* transaction. [*See Tobacco Products Export Corp.*, 18 TC 1100, Dec. 20,130 (1952).]

However, what if proposals are mutually exclusive alternatives, so that only one can be completed? The IRS' position in such a case is that no abandonment loss is proper unless the entire set of transactions is abandoned. In other words, the cost of pursuing any alternatives that are not consummated must be capitalized as part of the cost of the completed alternative.

Perhaps the best recent example of this (admittedly confusing) wrinkle is *United Dairy Farmers, Inc.*, CA-6, 2001-2 USTC ¶50,680, 267 F3d 510 (2001). In that case, costs of engineering studies to evaluate potential sites for a distribution plant were held to be capital, where the taxpayer intended to choose only one location to build the plant.

Mutually Exclusive

Applying this reasoning to the litany of choices facing this particular taxpayer in the TAM is a little confusing. The IRS first said that there were three main categories:

1. The status quo alternative
2. The recapitalization
3. The various divestiture choices

The IRS said that it was obvious that the first choice (status quo) was mutually exclusive with pursuing any restructuring. At the same time, the IRS said that it did not believe the taxpayer seriously considered doing nothing, or that any substantial portion of the costs in question were incurred in pursuing that option. (This latter point does make me wonder how one could spend money to investigate doing nothing.)

Next, the IRS said that choices two and three were clearly not mutually exclusive, and that the taxpayer could have entered into some type of recapitalization, and *also* done one or more of the divestiture transactions. Based on the authority in *Sibley, Lindsay & Curr Co.*, therefore, the TAM says the taxpayer can deduct under Code Sec. 165 any costs associated with the recapitalization because there was clear evidence of abandonment when the board voted to eliminate this option.

Spin vs. Split

Now it gets sticky. The divestiture choices and related costs are far more complex, and the IRS said it neither agreed entirely with its own field staff, nor with the taxpayer. The TAM said that the taxpayer really only pursued a single divestiture transaction, which really began when the board of directors voted to eliminate consideration of a spin-off or targeted stock offering. On that date, the board also approved a reorganization to place all of the assets of the lesser business divisions in a sub.

Two months later, the taxpayer actually formed the sub and transferred the assets and liabilities, and the deal went on from there. In other words, beginning with the board vote on this point, it was clear there was only one divestiture option on the table. Interestingly, the IRS draws little distinction between the split-off and spin-off, which the taxpayer had cast as quite separate alternatives. According to the TAM, the taxpayer modified the divestiture transaction from a split-off to a spin-off, and completed the spin-off less than two months later.

The IRS noted that generally speaking, a spin-off and split-off are very similar transactions, with similar mechanics and similar results. Indeed, the TAM says the end result of a split-off or spin-off would be the same for the distributing corporation—no longer owning any stock in the sub.

Conclusion

Here, the taxpayer was ruled to have pursued a single divestiture that meant any costs incurred in considering or pursuing an IPO, a split-off, a spin-off, *etc.,* had to be capitalized as part of the capital restructuring that was eventually accomplished. Moreover, although the taxpayer argued that it could deduct certain investigatory costs under Rev. Rul. 99-23, 1999-1 CB 998, the IRS held this ruling inapplicable to divisive transactions.

It is not always easy to say how you want consultants to bill. For that matter, is it also not always easy to determine precisely which services and which transactions go into billing by accountants, consultants, lawyers, and bankers. A timeline certainly helps, and perhaps more than anything else, the timeline was relevant and relied upon in TAM 200749013. Still, one can't help reading this without hearing in the background one of the continuing lessons of *INDOPCO:* bifurcate!

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