# Better Luck Next Time: Deducting Costs of Failed Business Transactions

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No one likes to focus on failure, but tax deductions are often a silver lining in the cloud of disaster. M&A lawyers often experience the thrill of gearing up to buy, sell or merge a business. However, many of these deals never get completed. Even so, their clients will want a definitive answer about the deductibility of the costs and fees incurred in preparing for those transactions.

The M&A TAX REPORT recently covered IPO costs. [*See* Wood, *To Deduct or Not to Deduct: The Cost of an IPO*, M&A TAX REPORT, Oct. 2005, at 7.] That article discussed the tax consequences of expenses incurred in an initial public offering (IPO) and the legal principle requiring costs incident to an IPO to be capitalized instead of deducted.

I recently represented a corporate taxpayer in an income tax examination involving the deductibility of costs. My client was a supermarket that began looking for a new and larger warehouse location for its business so it could consolidate its bakery and deli operations in one place. The taxpayer's old warehouse lease was due to run out, and the old space was too small for the current store. The taxpayer had hired a broker who located a building, and the parties conducted lease negotiations.

## Architectural Oops

However, when the building was completed, its structural design didn't work. It destroyed the effectiveness of the taxpayer's plan of accommodating both a warehouse and commissary. The parties discussed the lease of another building, but another party was also looking at that building.

Eventually, the taxpayer executed a sublease for the building with a third party. The taxpayer decided to install its tenant improvements in two phases. The first phase of the cooler/freezer had to be completed as quickly as possible to allow perishable items from the taxpayer's old warehouse to be moved into the new building. The taxpayer completed the first phase and moved into the building.

The taxpayer submitted its design plan for the second phase (a bakery) to the landlord. However, the landlord would not consent, as too many structural modifications of the building were called for. The taxpayer sued for declaratory relief allowing it to install its bakery in the building. There was a trial, and the court entered a judgment against the taxpayer. Two months later the court entered an order requiring the taxpayer to pay the defendant's attorneys' fees and costs.

## Share the Pain

The taxpayer deducted the attorneys' fees and costs paid to its own attorneys, as well as the defendant's reasonable attorneys' fees and costs. Ordinary and necessary business expenses are deductible under Code Sec. 162. The origin and character of the claim with respect to which an expense was incurred—rather than its potential consequences upon the fortunes of the taxpayer—is the controlling test of whether an expense is business or personal. [*D. Gilmore*, SCt, 63-1 USTC ¶9285, 372 US 39, 83 SCt 623 (1963).] If a taxpayer's litigation expenses and professional legal fees were paid in connection with its business, they should qualify as expenses paid or incurred in carrying on a trade or business, within the meaning of Code Sec. 162. [*See W.F. Tellier*, SCt, 66-1 USTC ¶9319, 383 US 687, 86 SCt 1118 (1966).]

## A Good Lease Gone Bad

In my audit, I had to address the issue of limitations to the deductibility of expenses under Code Secs. 162 and 212, by Code Sec. 263(a)(1) and (2), which disallow deductions for "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate," or for amounts "expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." As interpreted by the regulations, these provisions prohibit any deductions for "the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year," or for "amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use." [Reg. §§1.263(a)-2(a) and 1.263(a)-1(b).]

Code Sec. 263 is supplemented by Code Sec. 263A, which was enacted in 1986. It generally requires the capitalization of both direct and indirect costs attributable to (1) producing real or tangible personal property to be used by a taxpayer in his trade or business or in an activity conducted for profit, and (2) producing or holding property for sale to customers in the ordinary course of business. Code Sec. 263A codifies and expands a number of cases that required taxpayers to capitalize a variety of indirect construction-related expenses, such as vacation pay, payroll taxes, health and welfare benefits, general overhead and some executive salaries. [*Idaho Power Co.*, SCt, 74-2 USTC ¶9521, 418 US 1, 94 SCt 2757 (1974).]

Thus, a taxpayer who uses his own equipment, facilities and staff to construct or improve an asset whose useful life extends substantially beyond the tax year may not currently deduct construction costs, such as tools, materials and labor, but must instead charge the items to a capital account, as if the taxpayer had purchased the property from another party.

The capitalization requirement has been applied to depreciation on the construction equipment owned by a power company and used to construct a new power plant. As explained by the Court in *Idaho Power Co.* [*id.*], the purpose of Code Sec. 263 is to reflect the basic principle that a capital expenditure cannot be deducted from current income. It prevents a taxpayer from using currently a deduction that is really attributable to later tax years when the capital asset becomes income producing.

It is axiomatic that whether an expenditure must be capitalized or deducted is just a matter of timing. Of course, timing is 95 percent of tax planning.

## *INDOPCO* Redux

In 1992, in *INDOPCO, Inc.* [92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039 (1992)], the Supreme Court held legal and investment banking expenses to facilitate an acquisition by another corporation were nondeductible capital expenses. In rejecting the taxpayer's argument that under *Lincoln Savings & Loan Ass'n* [71-1 USTC ¶9476, 403 US 345, 91 SCt 1893 (1971)], "creation or enhancement of an asset is a prerequisite to capitalization," the Court said that "the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure." To the Court, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.

Notwithstanding the broad sweep of *INDOPCO*, courts have continued to rely on *Lincoln Savings* if the issue can be decided by requiring capitalization on the narrower "separate and distinct asset" test. An expenditure must be capitalized if it either creates or enhances a separate and distinct asset, or creates a more than incidental benefit extending beyond the tax year it is incurred. *INDOPCO* has not been applied to require capitalization where the long-term benefits are "softer" and "more speculative" than the short-term benefits from an expenditure. *INDOPCO* also has not been applied where there is no future benefit produced. A deduction for expenses is allowable where there was an expectancy to have a long-term benefit when incurred, but which did not in fact produce such a benefit.

## Separate and Distinct Transactions

Even though the IRS may challenge the deductibility of costs and fees associated with a failed business transaction, the law has allowed the deductibility of abandoned plans for a merger or acquisition for over 70 years. In *Portland Furniture Manufacturing Co.* [30 BTA 878, Dec. 8592 (1934)], the taxpayer deducted costs of a planned (but failed) merger with one corporation in the year prior to a (successful) merger with another corporation. The IRS denied the deduction on the tax return, but the Tax Court allowed the deduction. This was a separate and distinct transaction, not part of the merger that was eventually completed.

With respect to failed business acquisitions, if a taxpayer engages in multiple separate and distinct transactions, costs properly allocated to abandoned transactions are deductible, even if other transactions are completed. [*Sibley, Lindsay & Curr Co.*, 15 TC 106, Dec. 17,788 (1950), *acq.* 1951-1 CB 3.] Indeed, if a taxpayer engages in a series of transactions and abandons one of those transactions, a loss is allowed even if the taxpayer later proceeds with a similar transaction. [*Tobacco Products Export Corp.*, 18 TC 1100, 1104, Dec. 20,130 (1952); *Portland Furniture Manufacturing Co. supra*; *Doernbecher Manufacturing Co.*, 30 BTA 973, Dec. 8606 (1934), *acq.* XIII-2 C.B. 6, *aff'd* CA-9, 36-1 USTC ¶9030, 80 F2d 573 (1935).] These cases allow a deduction upon the abandonment of separate and distinct transactions, even if subsequent or alternative independent transactions are pursued.

In *Levitt & Sons, Inc.* [CA-2, 47-1 USTC ¶9188, 142 F2d 795 (1944)], the court ruled that payments to settle a threatened lawsuit were ordinary and necessary business expenses. Part of the court's analysis focused on the fact that the payment had not been part of the cost of the taxpayer's property, but was instead based on a fear of the effect on its business.

In *Hilton Hotels* [DC-Ill., 68-1 USTC ¶9215, 285 FSupp 617 (1968)], the court allowed appraisal expenses to be deducted as ordinary and necessary business expenses because they were conducted after the taxpayer reorganized. In that case, under state law, the taxpayer was required to purchase the shares of the dissenting shareholders. The IRS argued that the appraisal expenses were foreseeable as a consequence of the merger. However, the court held that the merger was already effective and the expenses incurred only related to the value of stock required to be purchased in the merger.

All these cases suggest that bifurcating as much as you can bifurcate is always good. That's the post-*INDOPCO* shuffle. Divide and conquer, bifurcate, trifurcate—you get the idea.

## Back to the Audit

In my audit of the supermarket, the taxpayer's lease had already been consummated, and the taxpayer had already moved in. Whether or not the litigation was foreseeable, it came *after* the lease was in place. The lawsuit for declaratory relief may have indeed produced a future benefit if the taxpayer had succeeded, but certainly it was not in connection with the acquisition of the original lease.

The future benefit that would have been produced would have been a commissary to produce all of the taxpayer's baked goods. Arguably, there would have been items that would have had to be capitalized in connection with this installation. However, the test is whether the expenditures add value to an asset or adapt it to a new or different use.

*INDOPCO* states that the test for capitalization under Code Sec. 263 is not whether expenditures create or enhance separate and distinct assets. The test is whether the costs result in the taxpayer realizing a future benefit—and it needs to be something more than an *incidental* future benefit. In my audit, the taxpayer's attempt to install a commissary was not successful. There were no commissary capital assets, and there was no future benefit.

Furthermore, not only was there no future benefit, but there was a detriment. The taxpayer was ordered to pay the defendant's legal fees as damages in connection with a dispute that eventually produced nothing. Luckily, the IRS Appeals Division saw things the same way I did—that the legal fees should be deducted and not capitalized. Yet, the expenses were disallowed on audit or we would not have been there. And, there was a considerable expense before this was all resolved. Perhaps that is proof that, like a bad penny, capitalization versus. deduction issues will plague the corporate acquisition arena—and considerably more pedestrian pursuits—for years to come.