IRS Determined a Subsidiary Stock Sale Does Not Make Prior Capitalized Transaction Costs Deductible

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A recent Technical Advice Memorandum (TAM) issued by the Internal Revenue Service (IRS) National Office concludes that a target company required under Internal Revenue Code Section 263(a) regulations to capitalize costs that "facilitated" the acquisition of the target's stock cannot deduct those costs when the target is later sold by the acquiring corporation. Instead the TAM concludes that the target can only deduct such costs if and when it is liquidated.

In TAM 202004010 (Jan. 24, 2020), a taxpayer acquired a target company in a taxable reverse triangular merger to achieve cost synergies that would generate long-term growth and increased efficiencies. The target company had paid professional fees and administrative expenses in connection with the transaction to several law firms, investment firms, accounting firms and other professional firms and determined that a portion of the fees and expenses was required to be capitalized because it was paid in the process of investigating or otherwise pursuing the sale of its stock to the acquirer. The target company also determined that a portion of the fees was a "success-based fee" for which the target elected the 70% deduction safe harbor provided by Rev. Proc. 2011-29 (which requires that the remaining 30% be capitalized).

The acquiring company later sold the target company stock to an unrelated third-party. On its consolidated corporate tax return for that year, when calculating the target's separate taxable income, the acquiring company claimed a Section 165(a) loss deduction for the previously capitalized transaction costs. The acquiring company argued that its position was consistent with the Supreme Court's analysis in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), where the Court held that certain professional investment, banking, and legal costs incurred by a target in the course of a friendly takeover were required to be capitalized under Section 263(a) because the target expected long-term synergistic benefits from its combination with the buyer, even if those benefits didn't give rise to a separate asset.

No Separate Asset Was Created

The TAM rejected the acquiring company's first argument that the synergistic benefits which the target received as a result of the acquisition gave rise to an "asset" for tax purposes, and that this asset became useless to the target upon the acquirer's sale of target's stock, resulting in a deductible loss. The TAM reasoned that the synergistic benefits did not meet the specific requirements of a "separate and distinct asset" under Treas. Reg. § 1.263(a)-4(b)(3), *i.e.*, a property interest of ascertainable and measurable monetary value that is subject to protection under applicable state, federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged separate and apart from its trade or business. The TAM stated that in any event, the costs related to a capital transaction, and thus were subject to capitalization under Treas. Reg. § 1.263(a)-5, not Treas. Reg. § 1.263(a)-4. Further, the TAM reasoned that *INDOPCO* was clear that capitalization is required in the case of costs that facilitate a capital transaction without the presence of a separate and distinct asset, which implied that no asset is in fact created in connection with such a transaction.

The Subsequent Sale of Target Stock Did Not Cause the Synergies To Disappear

The acquiring company further argued that, whether or not a separate asset was created, the target, in determining its separate taxable income, was entitled to claim a loss deduction for the previously capitalized transaction costs under Section 165(a) in the taxable

year the acquirer sold the target stock because at that point the synergies that provided the underpinning for capitalization under *INDOPCO* no longer existed, freeing up the capitalized costs for deduction. The acquiring company also reduced its basis in the target stock by a corresponding amount under the investment adjustment rules of Treas. Reg. § 1.1502-32. This resulted in the acquiring company reporting a reduced capital loss on the sale of the target and claiming an ordinary loss deduction as opposed to what may have been a difficult-to-deduct capital loss. The TAM rejected that argument as well, asserting that the Supreme Court's analysis in *INDOPCO* instructs that the capitalized costs must be capitalized for the duration of the target company's existence. According to the TAM, *INDOPCO* indicates that although a capital expenditure is normally amortized or depreciated over the life of the relevant asset, where no specific asset or useful life can be ascertained, the capitalized costs are deducted upon the dissolution of the enterprise. Based on that premise, the TAM concluded that a target company cannot claim a loss with respect to capitalized costs as long as it continues to exist as a corporation and continues to operate its business (*i.e.*, as a subsidiary of the buyer).

Going Forward

The first conclusion of the TAM regarding the creation of a separate and distinct asset is aptly supported by both the Supreme Court's holding in *INDOPCO*, as well as the Section 263(a) regulations. The second conclusion, however, is debatable. As a technical matter, although the Supreme Court's opinion in *INDOPCO* provides certain express language that could be read to support the TAM's second conclusion, the IRS's reliance upon this language should be tempered, as the Supreme Court's statements in this regard are merely *dicta*. In *INDOPCO*, the Supreme Court did not address a fact pattern that involved a subsequent event (like a sale of the target company) which could effectively make worthless the "long-term" synergistic benefits that were created by the original acquisition. As such, the Supreme Court has not directly analyzed or opined on whether a target's transaction costs should be deductible in a taxable year when the synergies created by an acquisition are negated by a subsequent sale. As a factual matter, such synergies may disappear upon the separation of the acquiring company and the target. If that is the case, any "long-term benefit" remaining after the sale to justify continued capitalization might be questioned.