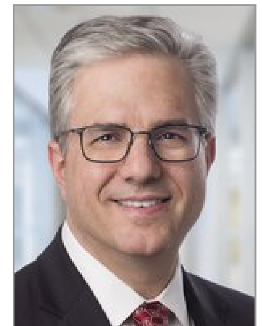
What Happens To IPO Costs When A Co. Later Goes Private?

By **Scott Rabinowitz, David Schneider and Sanessa Griffiths** (June 2, 2020, 5:58 PM EDT)

A corporation may not deduct previously capitalized costs that facilitated an initial public offering even when it later ceases to be a publicly traded company, according to an Internal Revenue Service Office of Chief Counsel internal memorandum that was recently made public.



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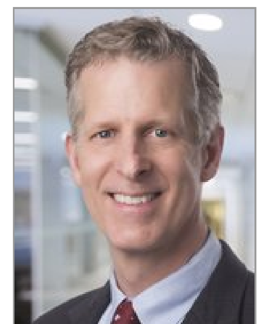
The memorandum is potentially relevant to any corporation that either has undergone, or may in the future undergo, an IPO.

In the memorandum's example,[1] the corporation was a private company in year one. In year two, it engaged in an IPO to become a publicly traded company, incurring legal, accounting, investment banking, underwriting, printing, and regulatory and filing fees in the process. The corporation did not net the costs against the proceeds from the stock issuance, but instead capitalized those costs as a separate and distinct asset.



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In year three, the corporation completed a take-private transaction (at that point ceasing to be a publicly traded company) and deducted, as an abandonment loss, the capitalized costs incurred in connection with the IPO from year two.

The corporation argued that the costs facilitating the IPO are required to be capitalized pursuant to the U.S. Supreme Court's decision in INDOPCO Inc. v. Commissioner[2] and Title 26, Section 1.263(a)-5 of the Code of Federal Regulations,[3] and that those authorities had overturned the IRS' prior position that stock issuance costs are to be netted against the proceeds of the stock issuance.

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In INDOPCO, 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 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.

Similarly, the corporation in the IRS memo argued that becoming a public company had resulted in future synergies and resource benefits, and therefore the costs facilitating the IPO should be viewed the same as expenses incurred in the purchase of an asset.

It asserted that when it became privately held, these intangible benefits ceased to exist, and thus the asset was abandoned, giving rise to a deductible loss under Section 165 of the Internal Revenue Code.[4]

Historically, the IRS has viewed costs that facilitate a pending stock issuance as giving rise to an intangible asset separate from the stock. If the stock is issued, however, the IRS has taken the position that the costs offset the proceeds of the stock sale.

In that sense, the costs are like commissions paid in the process of selling securities, which serve to reduce the amount realized on the sale.[5] The IRS has consistently maintained that the costs of the so-called asset are recoverable as a Section 165 loss only if the stock issuance does not happen — i.e., the transaction is abandoned.

Consistent with that longstanding position, Section 1.263(a)-5 of the regulations, which was issued about 10 years after the INDOPCO decision, requires taxpayers to capitalize costs that facilitate a capital transaction, including a stock issuance, public or private. However, the regulations are silent as to how a taxpayer is to further treat such capitalized costs.

In the memo, the IRS observed that INDOPCO required capitalization even absent a separate asset. The IRS further concluded that nothing about INDOPCO or regulation Section 1.263(a)-5 changes the established treatment of capitalized stock issuance costs as reducing the amount realized by the corporation on the stock issuance.

At the same time, under Section 1032 of the tax code,[6] corporations recognize no gain or loss on the issuance of their own stock. So, there is in effect no tax benefit derived from reducing the amount realized in an IPO by the amount of capitalized facilitative costs.

The corporation in the memo highlighted this fact, but the IRS was unpersuaded. The IRS responded that the corporation received a benefit in the form of not having to report the proceeds of the IPO in income, and that giving the corporation a further benefit through a deduction for the capitalized costs would be inconsistent with Section 265,[7] which disallows any deduction for costs allocable to tax-exempt income.

Moreover, the IRS concluded that no abandonment of assets occurred in the memo example. The IRS reiterated that "established precedent holds that costs incident to the sale of stock are never recoverable, except in instances where a planned public offering is abandoned," and rejected the corporation's argument that its take-private transaction was analogous to an abandoned IPO.

The IRS reasoned that, in the case of an abandoned IPO, no proceeds are available to offset the costs incurred, but that is not the case when an IPO is successfully completed, even if the corporation later goes back to being privately held.

Further, the IRS stated that even if the corporation had basis in the intangible benefits from the IPO, the claimed abandonment loss would not be available after the take-private transaction because the corporation "continues to benefit from once being a publicly traded company."

The memorandum is similar in certain respects to a technical advice memorandum, or TAM, that the IRS released in January, which concluded that a target company that had been required to capitalize costs that facilitated the acquisition of the target's stock, Sale 1, could not deduct those costs when the target is later sold by the acquiring corporation, Sale 2.[8] Instead the TAM concluded that the target can only deduct such costs if and when it is liquidated.

Thus, in both the TAM and the memorandum, the IRS took the view that a deduction of capitalized facilitative costs is not allowable simply because subsequent events undo the original capital transaction. That result seems clearer in the case of the memorandum than in the TAM.

While an argument may exist regarding whether the benefits of being publicly held are lost after a take-private transaction, it seems clear that the corporation had no basis in the capitalized costs, and thus no Section 165 deduction is available for the costs when the company undertakes a take-private transaction.

Further, as the memorandum points out, the taxpayer did not abandon the IPO transaction. Rather, the taxpayer completed the IPO. Accordingly, an abandonment loss under Section 165 is seemingly inappropriate.

Interestingly, the taxpayer in the memorandum apparently did not argue, as an alternative to abandonment, that a Section 165 loss was justified because the benefits obtained in the IPO became worthless when the company went private.

In the TAM then the real question is whether the target company's capitalized costs were freed up for a deduction upon completion of Sale 2. As with the memorandum, the second transaction, Sale 2, arguably is not the same thing as an abandonment of the first transaction, Sale 1.

Had the target company abandoned Sale 1, its capitalized transaction costs clearly would have been deductible in the year of abandonment. Thus, an abandonment loss under Section 165 may be equally questionable in the case of the TAM, notwithstanding that the target company in the TAM had basis in its costs.

However, Section 165 also permits a loss for assets that become worthless during the taxable year. The taxpayer in the TAM argued that the synergistic benefits target company received as a result of Sale 1 became worthless upon Sale 2 and should therefore be deductible. The IRS rejected that argument.

First, the IRS suggested that a worthlessness loss requires an asset, and because the costs that facilitated Sale 1 were not capitalized into any existing asset, and did not give rise to a separate and distinct intangible asset within the meaning of regulation Section 1.263(a)-4,[9] there could be no worthlessness deduction.

Second, the IRS concluded that the capitalized costs that facilitated Sale 1 benefitted the target's business as a whole, and therefore to claim a worthlessness deduction the taxpayer would have had to show that the entire business was worthless, which it could not.

The memorandum and the TAM are unlikely to end the debate about whether and when subsequent transactions can free up for deduction capitalized costs that facilitated previous capital transactions. The IRS in the TAM appeared to presume that a change in the capital structure of a corporation necessarily results in a benefit that lasts until the company is liquidated, no matter what happens afterward.

Although the Supreme Court's opinion in INDOPCO contains certain language suggesting that changes in corporate structure benefit the corporation's trade or business for its duration, the IRS' reliance on this language should be tempered given the Supreme Court's statement was dicta.

In INDOPCO, the Supreme Court was not asked to, and did not, opine upon the effect of a subsequent event like the sale of a target company.

If a worthlessness deduction under Section 165 is theoretically available upon executing the second transaction, then query whether the taxpayer really needs to show, as the TAM suggests, that the entire business is worthless, or whether the taxpayer need show only that the synergistic benefits that were created by the original transaction are worthless.

Further, even if the latter is the correct standard, as the IRS points out in the TAM, assets may not be considered worthless, even when they have no liquidated value, if there is a reasonable hope and expectation that they will become valuable in the future.

Absent a transaction that results in an actual or deemed liquidation of the corporation, it is unclear how taxpayers would show that no synergistic benefits from the original transaction remain upon completion of a second transaction.

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[1] https://www.irs.gov/pub/lanoa/am-2020-003.pdf.

[2] INDOPCO Inc. v. Commissioner , 503 U.S. 79 (1992).

[3] 26 C.F.R. § 1.263(a)-5.

[4] IRC Section 165 .

[5] See Rev. Rul. 79-2, 1979-1 C.B. 98 and Regulation § 1.263(a)-1(e), dictating that commissions and other transaction costs paid to facilitate the sale of property are capitalized and reduce the amount realized on the sale.

[6] IRC Section 1032 .

[7] IRC Section 265 .

[8] TAM 202004010 (Jan. 24, 2020).

[9] 26 CFR § 1.263(a)-4 .