Comments on Proposed Regulations Regarding Deduction and Capitalization of Intangible Asset Expenditures
REG125638-01

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Individual members of the Corporate Tax Committee of the Section of Taxation prepared the Comments. James L. Dahlberg exercised principal responsibility with input from William M. Richardson, Jasper L. Cummings, Jr. and R. David Wheat. The Comments were reviewed by John P. Barrie of the Section’s Committee on Government Submissions and by Joseph M. Pari, Council Director for the Corporate Tax Committee.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments, or they have advised clients on the application of these principles, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

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Comments on Proposed Regulations Regarding Deduction and Capitalization of Intangible Asset Expenditures

These comments address REG-125630-01, regarding the tax treatment of amounts incurred in acquiring, creating, or enhancing certain intangible assets or benefits (the “Proposed Regulations”). The Proposed Regulations were published in the Federal Register on December 19, 2002.

We commend the Internal Revenue Service (the “Service”) for taking the lead to provide guidance in an area that has been fraught with controversy. We believe that the treatment of transaction costs should correctly match income and expenses in any given period, and we welcome rules that will eliminate uncertainty in the treatment, as well as promote efficient administration, of these costs. In an effort to further achieve these goals, we respectfully submit our comments as they relate to: I. Transaction Costs, II. Stock Issuance Costs, and III. Capitalized Transaction Costs.

Executive Summary

I. Transaction Costs  Our comments address five proposed rules for acquisitive transactions, and one proposed rule for divisive transactions.

- Acquisitive Transactions.
  - The Facilitate Rule. Modify the rule to provide that an amount paid in pursuing an acquisition is facilitatory in nature only if it relates to activities performed on or after the earlier of (1) board of director approval of an acquisition proposal, or (2) the date the taxpayer executes a binding written contract to complete the acquisition.
  - Definition of Inherently Facilitative. Modify the definition of “inherently facilitative” costs to create a rebuttable presumption that such costs be capitalized.
  - Termination Fees. Amounts paid to terminate an existing agreement should not be per se capitalized; rather, such costs should be capitalized or deducted based only on the origin of the claim rule. Alternatively, the “expressly conditioned” rule of the Proposed Regulations should be clarified.
  - Success Based Fees. Success based fees are the norm in acquisition transactions. An example would be helpful to illustrate when a taxpayer has met its burden of proof by “clearly
demonstrative” evidence that the taxpayer is entitled to a deduction for such fees. An example regarding investment banking fees would be particularly helpful.

Hostile Takeover Defense Costs. Costs incurred to thwart a hostile takeover should be deductible regardless of whether such defense is successful, and regardless of whether the taxpayer incurs costs to find a white knight.

Divisive Transactions. Regardless of whether a disposition of assets is mandated, costs incurred by either a target or acquirer to dispose of assets should reduce the gain recognized on the disposition.

II. Stock Issuance Costs

The Proposed Regulations provide that stock issuance costs are not capitalized to the basis of an intangible asset. We believe that such costs do create an intangible asset and that such costs should be recoverable at some point.

III. Capitalized Transaction Costs

A blanket 15-year amortization for reorganization costs incurred in either an acquisitive or non-acquisitive tax-free acquisition is inconsistent with section 197(e)(8) and its legislative history. However, recovery of costs incurred by both an acquirer and target is appropriate. In the case of a tax-free asset acquisition, both acquirer’s and target’s capitalized transaction costs should be added to the basis of target’s assets (excluding cash) acquired. In the case of a tax-free stock acquisition, target’s capitalized transaction costs should be treated as creating an intangible asset.

Analysis

I. Transaction Costs

Our comments focus on the special rules applicable to certain trade or business acquisition and reorganization transactions under Prop. Treas. Reg. §1.263(a)-4(e)(4).
A. Acquisitive Transactions

(i) The Facilitate Rule

The Proposed Regulations reject the “whether and which” test of Rev. Rul. 99-23 and instead apply a “bright line” rule for capitalization of transaction costs. We believe adoption of a “bright line” rule is appropriate, but we believe that in order to accurately reflect business realities, any such rule should approximate a “final decision date.” However, we do not believe the rule adopted in the proposed regulations will accurately identify the “final decision date.”

As a threshold matter, regardless of whether a letter of intent documents a final decision, the issuance of a letter of intent is very unusual in a public deal. Typically, a “public deal” involves either an “exclusivity” agreement or a “no-shop” agreement. In both instances, it is clear that such agreements do not approximate a “final decision date,” and should not be treated as “similar” to a letter of intent. We are aware of situations, however, in which agents have suggested that such agreements are “similar to” a letter of intent. Such agreements only allow for confidential due diligence and rarely (if ever) document a final decision. In a typical “public deal,” no final decision is made until the board of directors approves the transaction.

Accordingly, we recommend that the rule provide that an amount paid in the process of pursuing an acquisition facilitates such acquisition only if the amount relates to activities performed on or after the earlier of – (1) the date on which an acquisition proposal is approved by the taxpayer’s board of directors (or committee of the board of directors), or (2) the date on which the taxpayer enters into a binding written contract to complete the acquisition.

By focusing on the earlier of board of directors approval or the date on which the taxpayer enters into a binding written contract, the test will in most cases be consistent with business realities as to which costs are truly pre-decisional and investigatory in nature, as opposed to facilitative in nature.

(ii) Definition of Inherently Facilitative

The Proposed Regulations also provide that transaction costs that are “inherently facilitative” must be capitalized. In general we agree with the proposed definition of “inherently facilitative,” but recommend that the definition be modified to create a rebuttable presumption that such costs be capitalized. The taxpayer should be entitled to successfully rebut the presumption with evidence, such as facts and circumstances, showing that the services generating such costs were performed in an

1 1999-1 C.B. 998.
attempt to help the taxpayer reach a “final decision.” For example, in some cases the magnitude of divestitures required by antitrust laws may very well be pivotal in the decision making process. Alternatively, the ability to consummate a transaction on a tax-free basis may be critical to the decision making process. In such circumstances, a taxpayer ought to be able to establish that costs incurred as a result of the regulatory or tax process were not “inherently facilitative.”

(iii) **Termination Fees**

Under the Proposed Regulations, if a transaction is “expressly conditioned” on the termination of an existing agreement, the amount paid to terminate, or facilitate the termination of, the agreement must be capitalized. We disagree with this rule because it is inconsistent with the longstanding “origin of the claim” rule. Whether a transaction is expressly conditioned on the termination of an existing agreement should not change the origin of the claim, as determined under well-established case law. In fact, regarding severance payments, it is our understanding that the Service and Treasury have adopted the origin of the claim rule, and that severance payments generally are deductible even if paid pursuant to an express condition in an acquisition agreement.

The following example illustrates our concern regarding the “expressly conditioned” rule. Consider a prepayment penalty or redemption premium associated with a loan. If an acquisition requires prepayment of the loan, which based on the original loan documents triggers the prepayment penalty or redemption premium, the prepayment penalty or redemption premium should not be capitalized. Indeed, existing regulations expressly provide for deducting the penalty or premium. Its origin is the original loan, not the subsequent acquisition.

(iv) **Success Based Fees**

The Proposed Regulations require capitalization of success based fees unless the evidence “clearly demonstrates” that such fees do not facilitate the acquisition. It is not clear how such a rule would be applied. Success based fees are the norm in almost every acquisition transaction. Accordingly, an example describing typical transactions with success based fees and when such fees would and would not be deductible would be very helpful in avoiding future disputes regarding application of this rule.

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3 *U.S. v. Gilmore*, 372 U.S. 39 (1962) ("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 basic test of whether the expense was ‘business’ or ‘personal’…."); and *Anchor Coupling Co. v. U.S.*, 427 F.2d 429 (7th Cir. 1970), cert denied, 401 U.S. 908 (1971) (applying *Gilmore*).
5 Treas. Reg. §1.163-7(c).
One important example of a typical transaction is as follows: An investment banker agrees to perform services that include becoming familiar with the business operations, financial condition, prospects and management of the client, advising and assisting management and the Board of Directors of the client in evaluating an acquisition proposal or alternative proposals, providing financial advice in connection with the acquisition proposal or alternative proposals, assisting in negotiating and structuring the terms of and implementing one of the proposals, and rendering a fairness opinion. The banker maintains no time records. Payment for the services is conditioned upon the closing of an acquisition or one of the alternative proposals.

In general, that portion of the investment banker’s fee that is associated with services that provide information which helps the client reach a final decision whether to proceed with an acquisition should be deducted. That portion of the fees associated with negotiating and structuring the transaction should be capitalized. A portion of the fees associated with rendering a fairness opinion should be deducted to the extent such services were for gathering information that the client used to reach a decision whether to proceed with the acquisition. The remaining portion of the fees associated with the fairness opinion should be capitalized. A letter from the investment banker, which describes the services performed and allocates the fee among such services, should constitute adequate evidence, notwithstanding the lack of time records.

(v) **Hostile Takeover Defense Costs**

We agree with the rule set forth in the Proposed Regulations that amounts paid to defend against a hostile acquisition attempt are not facilitative in nature. However, we recommend that an example be provided that involves the common situation of costs incurred to thwart a hostile acquisition attempt coupled with costs incurred to find a white knight. We believe that the example should provide that costs associated with thwarting a hostile acquisition attempt are deductible regardless of whether such defense is successful, and regardless of whether the taxpayer incurred costs to find a white knight. Similar to the “origin of the claim” rule discussed above in connection with the termination fee rule, the origin of the costs associated with thwarting a hostile acquisition is the hostile acquisition attempt. Such costs have nothing to do with investigating or facilitating an acquisition by a potential white knight.

**B. Divisive Transactions**

The Proposed Regulations provide that costs associated with selling assets in a transaction that is not described in section 368 are facilitative in nature and are required to be capitalized if incurred by an acquirer as part of a larger overall transaction in order to secure regulatory approval for a proposed acquisition of a target. In contrast,

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a target is not required to capitalize costs associated with selling assets that an acquirer
does not want. These rules raise two questions. First, what is the rationale for
distinguishing between sales that occur as a result of regulatory mandate (capitalize) and
those that occur because the other party to the transaction does not want the assets that
are disposed of (deduct)? Consistent with the “origin of the claim” analysis discussed
above, costs of disposing of assets should reduce the amount realized (or be capitalized
into asset basis). This is the general rule adopted in Prop. Treas. Reg. 1.263(a)-4(e)(3)(i).
The fact that the disposition is “mandated” does not change the origin of the claim.
Second, should there be a different rule depending upon (1) whether the taxpayer
disposing of assets is the target or acquirer, or (2) whether the disposition (or larger
transaction) is tax-free and if so, why? We believe the treatment generally should be the
same.

II. Stock Issuance Costs

The Proposed Regulations provide that amounts paid to facilitate a stock issuance
or a recapitalization are not capitalized to the basis of an intangible asset, but rather are a
reduction of the proceeds from the stock issuance or the recapitalization. The Proposed
Regulations are premised on what is believed to be existing law without analyzing what
the appropriate treatment should be. It is our view that regardless of whether existing law
may be read to support such a rule, treating stock issuance costs as a reduction of the
proceeds from the stock issuance is inappropriate for several reasons.

First, stock issuance costs are analogous to debt issuance costs--stock and debt
each provide capital for the taxpayer’s business. We acknowledge that debt issuance
costs have been treated differently from stock issuance costs. However, the general
principle in both cases is that an intangible asset is created. Second, if stock issuance
costs are truly an offset to proceeds, this would mean that such costs result in a
“discount” that may create a redemption premium for purposes of section 305(c). Clearly
this should not be the case. There is no “discount” because the offset does not result in a
transaction between the corporation and its shareholder, and therefore should not be
characterized as creating a dividend. Just as debt issuance costs are not interest, stock
issuance costs are not dividends.

Rather than treating stock issuance costs as an offset to proceeds, we believe that
the better view is that section 1032 covers the gross issue price of the stock, and stock

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9 Id.
11 See Emerson Electric Manufacturing Co., 3 B.T.A. 932 (1926) (the volume of the taxpayer’s business
necessitated raising additional capital), and Corning Glass Works v. Commissioner, 37 F.2d 798 (D.C. Cir.
1929) (the taxpayer decided to obtain capital by issuing stock because it was unable to obtain the requisite
funds by borrowing).
12 See Enoch v. Commissioner, 57 T.C. 781 (1972), cited in the preamble to the Proposed Regulations.
issuance costs should be treated as a separate payment, which creates a separate intangible asset.

As to the appropriate time to recover stock issuance costs, clearly it is not when the costs are incurred, because the stock issued generally does not have a definite life. However, the appropriate time should be when the corporation ceases to benefit from the stock issuance; e.g., generally when the stock is redeemed or liquidated. As to those cases where stock does have a fixed term, arguably costs associated with the issuance of such stock should be amortized over the term of the stock.\textsuperscript{13}

III. Capitalized Transaction Costs

The Preamble to the Proposed Regulations requests comments regarding the proper treatment of capitalized transaction costs. Specifically, there are several questions posited in the Preamble regarding transaction costs of a tax-free acquisition. Before addressing these questions, as a general proposition, we do not believe that a blanket 15-year amortization for costs incurred in a tax-free transaction is appropriate, whether it be in the context of an acquisitive or non-acquisitive tax-free transaction. Allowing for 15-year amortization would be inconsistent with section 197(e)(8) and the legislative history of that section. However, that does not mean that recovery for such costs is inappropriate. Quite the contrary. Our comments address when we believe recovery is appropriate in those situations set forth in the Preamble.

A. Acquirer’s Capitalized Transaction Costs in a Tax-Free Acquisition

Consistent with \textit{McCrory Corporation v. United States},\textsuperscript{14} an acquirer’s capitalized transaction costs in a tax-free acquisition should be added to the acquirer’s basis in the target’s stock or assets acquired (excluding cash). This addition presumably would be made proportionately, based on the relative fair market value of the assets acquired, and recovered as the basis of the acquired assets or acquired stock is recovered. Section 362(b) does not address the acquirer’s capitalized transaction costs and thus should not be construed to preclude increasing the basis of acquired stock or assets to reflect capitalized transaction costs.

B. Target’s Capitalized Transaction Costs in a Stock Acquisition

Consistent with dicta in \textit{INDOPCO, Inc. v. Commissioner},\textsuperscript{15} and \textit{FMR Corporation and Subsidiaries v. Commissioner},\textsuperscript{16} a target’s capitalized transaction costs

\textsuperscript{13} \textit{But see Commercial Investment Trust Corp. v. Commissioner}, 28 B.T.A. 143 (1933) (no amortization of preferred stock issuance costs.)

\textsuperscript{14} 651 F.2d 828 (2d Cir. 1981).

\textsuperscript{15} 503 U.S. 79 (1992).

in a tax-free acquisition that is treated as a stock acquisition should be viewed as a separate intangible asset with an indefinite useful life.

C. Target’s Capitalized Transaction Costs in a Tax-Free Asset Acquisition

We believe that a target’s capitalized transaction costs in a tax-free asset acquisition should proportionately increase target’s basis in all of its assets (excluding cash) immediately before the transaction. Support by analogy for such a position can be found in *Kirschenmann v. Commissioner.*\(^{17}\) *Kirschenmann* involved an installment sale where the court concluded that selling costs are an adjustment to the seller’s basis in property sold rather than a direct reduction of the selling price.

D. Application of the Safe Harbor to Tax-Free Non-Acquisitive Transactions

The Preamble raises the issue whether the safe harbor amortization provisions should apply to capitalized transaction costs in non-acquisitive transactions such as transactions under sections 351 and 355.

In our view, the principles of capitalization and cost recovery should be the same, whether a tax-free transaction is acquisitive or non-acquisitive.

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Again, we commend the Service in taking the lead in providing rules that are intended to provide guidance and simplicity in an area that, by its very nature, is factual.

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\(^{17}\) 488 F.2d 270 (9th Cir. 1973).