TAX ACCOUNTING

BY JAMES E. SALLES

This month's column discusses the IRS positon — and the evolving case law — addressing when a corporate taxpayer can deduct the expense of resisting its own takeover.

IRS STICKS TO ITS GUNS ON TAKEOVER COSTS

A recently released field service advice (FSA)[1] confirmed that the IRS is not abandoning its position that "defense costs" which a target incurs in resisting a hostile takeover must be capitalized along with the other corporate-level costs of the acquisition if the takeover is ultimately successful.

The Supreme Court's 1992 decision in *INDOPCO, Inc. v. United States*[2] left unresolved several questions about treatment of the target's expenditures in corporate transactions that are still being fought out in the courts and elsewhere today. (The *acquirer's* expenditures do not present these issues. A successful transaction yields an "asset," and any associated outlays form part of its cost.[3] An abortive transaction generally produces a deductible loss, absent some alternative transaction being in the picture or other special circumstances.)

The *INDOPCO* Holding

INDOPCO involved a friendly acquisition in which some shareholders of the target (National Starch) received stock in a special purpose subsidiary of the acquirer (Unilever), and the rest were cashed out. The issue was whether fees the target paid to its investment bankers and others, and associated miscellaneous costs, were currently deductible or had to be capitalized. The taxpayer's position was that the target's expenditures were not capitalizable because it did not acquire a "separate and distinct asset," loosely translatable to a property interest transferrable for value. This argument was distilled from a remark in the Supreme Court's earlier decision in *Commissioner v. Lincoln Savings & Loan*, and like many other attempts to generalize from a particular holding in this analytically untidy area, proved too much. The cost of organizing corporations and other entities, of various kinds of recapitalizations and reorganizations, and the cost of issuing stock have consistently been held capital, without any "separate and distinct asset" in the picture. Accepting the taxpayer's argument would have turned 50 years of case law upside down.

The Supreme Court made short work of the taxpayer's *Lincoln Savings* argument, ruling that while "a separate and distinct asset well may be a sufficient"[4] condition for capitalization it was not a necessary one. In the Court's view, the crucial consideration in determining whether capitalization applies — an "undeniably important" one, anyway, and the only one it discussed — is the degree to which the taxpayer realized a benefit beyond the year in which the expenditures were incurred. Although Internal Revenue Code Section 263's mandate to capitalize "permanent improvements or betterments" directly refers to tangible property, the Court noted that this language "envisions an inquiry into the duration and extent of the benefits realized by the taxpayer," and further supported its conclusion as to the primacy of this "future benefit" inquiry.

The record in *INDOPCO* furnished ample evidence of "future benefit" from the acquisition. The taxpayer had stated publicly that it expected synergies to result from combining businesses, and the Court also found that it had improved its capital structure when it exchanged many public shareholders for one. Therefore, the Court concluded, the taxpayer's expenditures in connection with the buyout were capital.

Hostile Takeovers: *Federated Department Stores*

INDOPCO settled one question, but highlighted several others, even in its immediate factual neighborhood — the treatment of expenditures incurred in a merger.

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There seems little room to argue that a deal that involves related parties, or is friendly from the outset, does not provide a future benefit: why else would the parties do it? However, hostile takeovers (or hostile-turned-friendly takeovers), or failed attempts at them, provoke some obvious questions with less than obvious answers.

Assuming a hostile takeover is successful, a target corporation has two overlapping but analytically distinct arguments for an ordinary deduction for the expenditures of its unsuccessful defense. One is that the transaction provided no benefit. The other is that the defense costs are not attributable to the transaction as finally consummated because they were incurred to impede it, not to bring it about.

In re Federated Department Stores[5] presented both these arguments against the backdrop of two separate hostile acquisitions by the Campeau group. In each case, the target negotiated a buyout with a potential "white knight," which Campeau forestalled, leaving the target to pay both a "break-up fee" to the "white knight" and investment bankers' and other fees. The bankruptcy court found that the "failed mergers [with the "white knights"] and the ultimate takeovers by Campeau were not beneficial in any common sense of the word" — not surprising, as both targets filed for bankruptcy soon after — and also that the dealings with the "white knights" actually discouraged the ultimate transactions with Campeau by making them more expensive. The court concluded that the defense costs were deductible under Code Section 162, and for good measure also as losses under Code Section 165. On appeal, the district court agreed, distinguishing *INDOPCO* as a case where the expenditures contributed to a friendly acquisition that provided a future benefit.

Victory Markets

The taxpayer in *Victory Markets, Inc. v. Commissioner*[6] was likewise contacted out of the blue by a potential acquirer. By way of protecting itself against a potential attempt at a hostile takeover, it began discussions with various potential "white knights," and also adopted a "poison pill" plan and signed employment contracts with senior management. Unlike the circumstances in *Federated*, however, amicable negotiations with the original suitor continued, and a deal was ultimately cut when the bid was raised sufficiently.

The taxpayer argued, citing *Federated*, that *INDOPCO* applied only to the costs of friendly acquisitions, while this acquisition had been at least potentially hostile, and therefore its defense costs should be currently deductible. However, the Tax Court held that the taxpayer's expenditures were capital — regardless of the scope of *INDOPCO* — because there had been a friendly acquisition that provided the target with various benefits, including better access to capital to embark on an acquisition spree of its own. The court did not reach the second potential issue, probably because the discussions with potential "white knights" had been only preliminary, and the taxpayer evidently did not dispute that all the costs were attributable to the ultimate acquisition.

A.E. Staley Manufacturing

The most recent case in this series, *A.E. Staley Manufacturing Co. v. Commissioner*,[7] is also the most controversial. The taxpayer in *Staley*, fearful of a hostile takeover and suspecting that arbitrageurs intended to sabotage its stock offering, engaged investment bankers, adopted anti-takeover measures, and began shopping around for friendly investors, including the British sugar refiner Tate & Lyle. Tate & Lyle, however, broadened its ambitions, acquiring additional stock and refusing to enter into a standstill agreement, and it eventually launched a hostile tender offer. The taxpayer's board and management did not favor the offer and, unlike in *Victory Markets*, did not immediately enter into negotiations. They did, however, engage investment bankers to value the stock and advise them about their options, under an agreement that called for payment of a premium contingent upon an acquisition or recapitalization. When the investment bankers were unable to find a better alternative, the target began negotiations with Tate & Lyle, culminating in an agreed-upon buyout at approximately 15 percent above Tate's initial bid. Tate & Lyle sold off one of the taxpayer's major operating subsidiaries to finance the takeover, and made a clean sweep of management.

The issue was the deductibility of the investment bankers' fees and printing costs incurred in the struggle. The taxpayer argued that unlike in *Victory Markets*, the acquisition served no corporate purpose. The target lost its historical management, and one of its historical businesses, and far from receiving a fresh infusion of cash, was plundered to pay for its own acquisition.

The Tax Court, ruling *en banc*, nonetheless held that the challenged expenditures were capital because they ultimately led to the acceptance of Tate & Lyle's enhanced offer. The court reasoned that the target owed a fiduciary duty to the stockholders, and the *stockholders* benefited from being bought out at a good price. Management's lack of enthusiasm was beside the point.[8] Thus, the court concluded, the case was essentially the same as *Victory Markets*.

As noted in a vigorous dissent by five judges, the Tax Court's *Staley* holding went considerably beyond *Victory Markets*. The court essentially imputed the shareholder-level benefit to the corporation for purposes of the *INDOPCO* "future benefit" inquiry. As selling shareholders benefit — or at least, in the short run, cannot be proven not to — from pretty much any acquisition, the Tax Court position would seem to allow no deduction at all when there is ultimately a successful deal, except maybe if the target liquidates immediately thereafter.[9]

The Tax Court in *Staley* also noted — as did the Supreme Court in *INDOPCO* — that the target reaped savings from ceasing to be a public company, but this argument suffers from the common problem of proving too much. The target would also be spared these costs if it liquidated, although even the opinion in *Staley* implied that there would be no future benefit in that case. Moreover, a lengthy parade of cases consistently hold that an outlay that merely reduces future costs — for example, a payment to escape an onerous lease — does not provide a future benefit, and is not capital unless something else is going on. Unless these cases were somehow overruled by the Supreme Court's casual aside in *INDOPCO*, the savings from going private, standing alone, should not furnish sufficient basis for capitalization. The ultimate underpinning for the Tax Court's holding was its conclusion that the corporation must have benefited because its shareholders did.

On appeal, the Seventh Circuit reversed. Interestingly, the circuit court did not directly confront the Tax Court's determination that there was a corporate-level benefit from the acquisition. The taxpayer was, after all, in the hands of the acquirer, and the new management may have fought shy of an explicit argument that their takeover had done the target no good. (This was not a problem in *Federated*, where the argument was made by the bankruptcy trustee.) Instead, the appellate opinion handed the taxpayers a victory on the second potential ground discussed above: the attribution of costs to the transaction. Virtually all of the fees at issue, the court concluded, were for activities that were designed not to promote the deal, but to "frustrate" it, and were thus deductible. Only a small portion of the fees that were attributable to "facilitative" functions performed after the target had thrown in the towel were capital.

FSA 200103004 and the IRS Position

The IRS has made no bones about its disagreement with the Seventh Circuit's holding in *Staley*. A few months after the decision, a branch chief remarked that "[i]f the same facts arise in another circuit, my guess is that our litigating position will not be changed."[10] That seems to still represent the IRS thinking.

FSA 200103004 involved legal and investment bankers' fees incurred by a publicly traded company in an effort to fend off acquisition by a partnership in what appears to have been a leveraged buyout. The target's efforts were unsuccessful, and it emerged from the transaction with new owners and saddled with a lot of new debt. While conceding that the taxpayer's argument that the new debt meant the target had derived no benefit had some "initial practical appeal," the IRS rejected it, along with the Seventh Circuit's conclusion that only expenditures "directly facilitating" the final transaction should be capitalized. The ruling commented that these arguments "ignore the tenet that expenses incurred in connection with the creation and adoption of a shareholder rights plan or other corporate capital structure should be capitalized."

The evolving IRS position, therefore, seems to be that (1) any corporate transaction which the target survives provides future benefits; and (2) any takeover-related expenditures in the period leading up to the deal — including those incurred to resist it! — form part of its cost. The first conclusion follows the reasoning of the Tax Court in *Staley*: Change is always good, at least for the target shareholders. The rationale for the second conclusion — although rarely explicitly articulated — seems to be that all takeover-related expenditures, if nothing else, contribute to driving up the price ultimately paid.

If there are multiple potential "separate and distinct" transactions, then the IRS concedes that any costs relating to abandoned transactions are deductible, even though other similar transactions may be consummated, either contemporaneously or later on. On the other hand, if multiple *alternative* transactions are pursued, the IRS position appears to be that if *any* of them go through then *all* the associated costs must be capitalized.[11] This formulation makes traditional "white knight" costs always capital, because by definition they represent the costs of exploring alternative transactions. It does not easily allow, however, for expenditures that may be incurred strictly to resist a tender offer, for example, and do not facilitate any transaction at all. The factual discussions in various private rulings — and FSA 200103004 — leave the door open just a tiny crack. It is therefore conceivable that, on exactly the right facts, the IRS might be brought to acknowledge that certain costs incurred in the takeover context did not contribute to *any* alternative transaction, although its existing pronouncements are not particularly encouraging.

Alternative Transactions

The same types of issues arise when it is the "white knight" deal, or another alternative transaction, that winds up going through, and the question is what outlays have to be capitalized into the cost of *that* transaction. The IRS issued twin private rulings in this setting while *INDOPCO* was still making its way through the courts.

In Private Letter Ruling (PLR) 9043003, an insurance company, worried that a potential acquirer wanted to pump it dry of cash, began shopping around and ultimately found a friendly suitor that not only bought its stock but provided a substantial capital infusion. To head off a potential bidding war, the target reached a "standstill agreement" under which it made a payment to its original suitor. The ruling held that while litigation costs and other payments for services to "directly resist" the threatened hostile takeover were deductible, most of the other costs were part of the cost of the friendly acquisition and thus had to be capitalized. The National Office specifically found that the payment under the "standstill agreement" was made "to facilitate the smooth acquisition of . . . stock" by the ultimate buyer and therefore had to be capitalized.

PLR 9043004 involved similar facts except that there was a more explicit bidding war, which was resolved by a standstill agreement. Again, the IRS ruled that expenditures that were not "directly" connected with resisting the hostile bid had to be capitalized, including the payment under the standstill agreement.

By contrast, while the Seventh Circuit in *Staley* also noted that some expenditures that were initially directed at resisting a hostile takeover might have to be capitalized if they contributed to a friendly transaction that provided a benefit, the example it gave of such "dual purpose" expenditures involved "those expenses related to the evaluation and facilitation of the friendly acquisition."[12] Again, therefore, there seems to be a split of authority. The IRS would favor at least a strong presumption that all takeover-related expenditures contribute to arriving at the final transaction, while the Seventh Circuit would capitalize only those expenditures that "facilitate" the transaction that finally takes place. FSA 200103004 does not directly address these facts except to the extent that it confirms that the National Office is still at least as hawkish about capitalization as it was in 1990.

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1. FSA 200103004 (9/11/00).
2. 503 U.S. 79 (1992).
3. Woodward v. Comm'r, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970).
4. 503 U.S. at 87.
5. 135 B.R. 950 (Bankr. S.D. Oh. 1992), *aff'd*, 171 B.R. 950 (S.D. Oh. 1994).
6. 99 T.C. 648 (1992).
7. 105 T.C. 166 (1995), *rev'd and rem'd*, 119 F.3d 482 (7th Cir. 1997).
8. Cf. Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Gilmore, 372 U.S. 39 (1963), discarding an inquiry into the "primary purpose" for incurring litigation costs in favor of a focus upon the "origin of the claim."
9. 105 T.C. at 197.
10. *See* S. Stratton, "IRS Highlights Upcoming Accounting Method Change Guidance," 78 *Tax Notes* 538 (Feb. 2, 1998).
11. *See*, *e.g.*, PLR 9402004 (9/10/93).
12. 119 F.2d at 489 n.6.