Office of Chief Counsel
Internal Revenue Service

# memorandum

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HPLevine, ID# [redacted]

date: JUN 30 2000

to: Chief, Examination Division, Kentucky-Tennessee District
Revenue Agents Carla Bellanfant

from: District Counsel, Kentucky-Tennessee District, Nashville

subject: [redacted] (Acquisition)
Capitalization of acquisition costs

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ISSUE:

Whether the taxpayer must capitalize acquisition costs that it incurred in the acquisition of the assets of a business?

CONCLUSION:

The taxpayer must capitalize acquisition costs that it incurred in the acquisition of the assets of a business.

FACTS AND DISCUSSION:

The taxpayer deducted approximately [redacted] dollars in costs that it claimed that it incurred in connection with the purchase of all of the assets of a business [redacted] for $[redacted]. The costs included those of consummating the transaction and due diligence costs. All of these costs were incurred after the letter of intent was signed. The taxpayer now indicates that it will settle for a [redacted]-year depreciation deduction under I.R.C. § 195.

Expenditures incurred in connection with organizing, recapitalizing or merging a business are not currently deductible. INDOPCO v. Commissioner, 503 U.S. 79 (1992); FMR Corp. v. Commissioner, 110 T.C. 402 (1998). Where a taxpayer receives significant, long-term benefits as a result of the expenditures it incurred in connection with facilitating a capital transaction, the costs must be capitalized. Id. It is undisputed that costs incurred in connection with facilitating a capital transaction, that is, an acquisition, must be capitalized. American Stores Company v. Commissioner, 114 T.C. No. 27 (May 26, 2000). Instrumental to the court's opinion in American Stores Company v. Commissioner, supra, was the fact that the court found that the objective of the merger transaction had long-term benefits, to wit, a greater market share, greater operating efficiencies in the combined operations and adoption of the management/operating policies of the acquired entity.

The Internal Revenue Service in Rev. Rul. 99-23, I.R.B. 1999-20 clarified the extent that expenditures by a taxpayer in the course of a general search for or investigation of an active trade of business were permitted to be amortized as "start-up" expenses under I.R.C. § 195. Rev. Rul. 99-23 does not apply to this case since it applies only to entities not already in a trade or business being considered.[1] The taxpayer was already engaged in the health care business and this was merely an expansion of that business. Therefore, it is already entitled to deductions under I.R.C. § 162 to the extent that there are allowable investigatory expansion costs.

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[1] I.R.C. § 195 was enacted to equalize the tax treatment between entities allowed to deduct expansion costs and those "start-up" entities who could not do so because they could not satisfy the I.R.C. § 162 "trade or business" requirement. NCNB v. United States, 684 F.2d 285 (4th Cir. 1982); Richmond Television Corporation v. United States, 345 F.2d 901 (4th Cir. 1965).

Rev. Rul. 99-23 is an attempt to provide guidance for amortizable investigatory expenses under I.R.C. § 195. A requirement under I.R.C. § 195 is that the expenses must have been allowable under I.R.C. § 162 if the trade or business requirement was met. Therefore, the discussion in Rev. Rul 99-23 may prove instructive.

Under Rev. Rul. 99-23, expenditures incurred in a general search for or investigation of an active trade or business qualify as investigatory costs and are amortizable under I.R.C. § 195. Start-up costs are defined by reference to costs allowable to an existing business which are incurred in connection with investigation of expansion possibilities which were otherwise already deductible. These costs are in general those which are generic to a determination as to whether to enter into a business or market and include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities and like expenses. Rev. Rul. 99-23. It is important to note that these expenses are not those incurred prior to a final decision to acquire a specific business, but whether to enter into that business at all. See Rev. Rul. 99-23. See also Rev. Rul. 77-254, 1977-2 C.B. 63 (expenses incurred in the course of a general search for or an investigation of a business that relate to decisions as to whether to purchase a business and which business to purchase are investigatory costs). Rev. Rul. 99-23 provides the following examples illustrative of these distinctions:

1. Costs incurred to conduct industry research and evaluate publicly available financial information are investigatory costs. Costs incurred to review specific financial information of proposed target to establish purchase price are capital since they were incurred after the decision was made to enter into the new business.

2. Costs incurred to draft regulatory approval documents are capital no matter when they were incurred since the costs were incurred to facilitate and not investigate the acquisition of a business.

3. Due diligence costs including review of internal documents, books and records and drafting acquisition agreements pertain to the attempt to acquire a specific business and are not eligible for amortization under I.R.C. § 195.

In this case, you indicate that the acquisition costs relate to consummating the transaction and due diligence costs. They were all incurred after the letter of intent was signed. These costs were incurred after the decision to acquire a specific business had been made. The nature of these expenses are directed to the acquistion of the assets, a future benefit. Therefore, the costs must be capitalized.

Because of the technical nature of this issue, we are seeking post-review by the National Office of the advice contained herein. We expect to hear shortly from them. Attached is a client survey which we request that you consider completing. Please contact the undersigned at 250-5072 if you have any questions.

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By

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