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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Douglas A. Fahey
Assistant to the Branch Chief CC:ITA:3

SUBJECT: Request for Chief Counsel Advice –

This Chief Counsel Advice responds to your memorandum dated February 26, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Year 1	=
Date 1	=
Date 2	=
Date 3	=
Taxpayer	=
Target	=
t	=
<u>u</u>	=
<u>v</u>	=
<u>w</u>	=
<u>x</u>	=
<u>y</u>	=
<u>\$a</u>	=
<u>\$b</u>	=
<u>\$c</u>	=
<u>\$d</u>	=
<u>\$e</u>	=

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\$f =
\$g =
\$h =
\$i =
\$j =
\$k =
 Executive A =
 Executive B =

ISSUE

Whether the proposed treatment of Taxpayer's contributions to an irrevocable grantor trust to fund an employee bonus plan is appropriate under the developed facts and circumstances of this case.

CONCLUSION

We agree that the proposed treatment is appropriate, subject to the further factual development discussed below.

FACTS

Target was a closely-held corporation in the business of t. On date 1, Taxpayer and Target's shareholders entered into a stock purchase agreement, under which Taxpayer agreed to purchase 100% of Target's outstanding stock for cash. The purchase price for the stock was \$a, payable at closing. Among the conditions precedent to closing were requirements that (1) Target had to enter into employment and retention agreements and noncompete covenants with several specifically identified officers and employees¹; and (2) Target had to establish an employee bonus plan, to be funded by Taxpayer, for the benefit of Target's nonshareholder employees after the acquisition. The agreement provided that Taxpayer would contribute a total of \$b to an irrevocable grantor trust in order to fund the bonus plan, \$c at the time the trust was established and \$d on date 3.

The acquisition transaction closed on date 2. Taxpayer acquired all of the outstanding stock of Target, and Taxpayer and Target each made an election under

¹ Taxpayer also agreed to establish a retention bonus of (i) w of annual base pay, payable x years after the closing to continuing employees of Target, and (ii) up to y of annual base pay, payable u years after the closing to continuing employees of Target, to be developed jointly with Target's senior management and approved by Target's stockholders.

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§ 338(h)(10) with respect to the sale and purchase of Target's stock. Immediately following the acquisition of Target, Taxpayer merged it into a single-member limited liability company owned by Taxpayer. Thereafter, Target was operated as a division of Taxpayer for federal income tax purposes. Taxpayer treated \$f as the purchase price of the stock, allocating that amount among the various assets of Target, grouped by classes I-V, using the residual method. The amount allocated to Class V assets (§ 197 intangibles in the nature of goodwill and going concern value) was approximately \$k, which was amortized over 15 years.

The employee bonus plan was established on the same date. It is administered by a Plan Committee, which was appointed by the board of directors of Target, and is essentially an arrangement for the payment of bonuses to plan participants over a period of u years, provided the employees remain employed by Taxpayer on each of v dates following date 2, the date of the acquisition.² Each participant is a nonshareholder employee of Target. The stated purpose of the bonus plan is to encourage employee participants to continue to devote their best efforts to the business of Target by rewarding such employees for services that contribute to the success of the enterprise. Taxpayer made an initial contribution of \$e to the irrevocable trust to fund the plan on date 2 and a second contribution of \$d on date 3. Although the initial stock purchase agreement had provided for a purchase price of \$a for Target's stock and an initial contribution to the bonus plan of \$c, Taxpayer actually paid \$f for Target's stock, or \$g more for the stock, and decreased its initial contribution to the trust for the bonus plan to \$e, or \$g less than originally agreed. The aggregate total of consideration paid by Taxpayer remained the same at \$h.

Under the bonus plan, an "account" was set up for each participant based on such participant's "allocable share" of the bonus plan funds. Taxpayer has not provided any information concerning how each participant's "allocable share" was determined, other than that they were "predetermined." The value of the participants' allocable share ranges greatly, from \$i to \$j. Taxpayer did not claim a current deduction for its initial \$e contribution to the bonus plan. Taxpayer did,

² Participants who do not remain employed with taxpayer because of one of the following conditions are nonetheless fully vested in their account balance: (i) death, (ii) disability, (iii) retirement from employment at or after reaching age 65, (iv) discharge from employment at the direction of Target other than for cause, (v) resignation from employment for good reason, or (vi) termination of employment with Target following a change in control, prior to the full distribution of the Participant's Account. If a participant ceases to be employed by Target for any other reason, the participant's account balance is forfeited. Amounts remaining in the trust, if any, on the date of its termination revert to Target.

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however, treat vested amounts distributed to participants during year 1 as taxable wages to participants subject to federal withholding and FICA taxes. For its own purposes, Taxpayer treated the vested amounts as deductible compensation and as research expenses qualifying for the research credit.

LAW AND ANALYSIS

Section 402(b) of the Code provides that the value of an employee's interest in an employees' trust that is not exempt from tax under § 501(a) is included in the gross income of the employee in accordance with § 83, that is when the interest becomes substantially vested, as defined in the regulations under § 83. The employer is entitled to a compensation deduction for contributions to such a trust in the taxable year in which an amount attributable to the contribution is includible in the gross income of a participant, provided the contribution otherwise meets the requirements of § 162. See § 83(h) and § 1.83-6, § 404(a)(5) and §1.404(b)-1T of the Income Tax Regulations. Accordingly, the central issue in this case is whether the taxpayer's contributions to the trust constitute deductible business expenses within the meaning of § 162. Stated differently, if the contributions are part of the aggregate consideration for Target's stock, or are allocable to the acquisition of a separate intangible asset, such as an assembled workforce, then the contributions would not otherwise meet the requirements for deductibility under § 162.

Capitalization v. Current Deduction

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. In order to be deductible under § 162(a), an expenditure must be: (1) an expense; (2) ordinary; (3) necessary; (4) incurred during the taxable year; and (5) made to carry on a trade or business. Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345 (1971). Additionally, § 1.162-7 of the regulations provides that payments for compensation must be reasonable and must be in fact payments purely for services in order to constitute deductible business expenses.

Section 263(a) generally provides that no deduction shall be allowed for the cost of permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-2(a) provides that the costs of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year are capital expenditures. Section 161 clarifies that deductions against gross income allowed under Part VI of Subtitle A (which includes § 162) are subject to the exceptions set forth in Part IX of Subtitle A (which includes § 263). Thus, the

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capitalization rule of § 263(a) takes precedence over the § 162 rules for deduction of business expenses.

An expenditure is capital if it creates or enhances a separate and distinct asset, Lincoln Savings, 403 U.S. 345, or produces a significant long-term benefit. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). A capital expenditure is not an “ordinary” expense within the meaning of § 162(a). Lincoln Savings, 403 U.S. at 354; INDOPCO, 503 U.S. at 87-88. Costs incurred in connection with the acquisition or disposition of a capital asset are to be treated as capital expenditures. Ancillary expenses incurred in acquiring or disposing of an asset are as much a part of the cost of that asset as is the price paid for it. Woodward v. Commissioner, 397 U.S. 572 (1970).

In order to determine whether an expenditure is capital or deductible, we look to the origin and character of the claim or transaction for which the expenditure is incurred. Woodward v. Commissioner, 397 U.S. 572, 577-78 (1970); United States v. Gilmore, 372 U.S. 39, 47 (1963). Here, Taxpayer argues that the operative “transaction” (whose origin and character are to be examined) is Taxpayer’s obligation to make the bonus payments as the participants become vested in the allocated shares. Although Taxpayer concedes that the establishment and funding of the bonus plan occurred simultaneously with the acquisition of Target, Taxpayer relies on the fact that its obligation to distribute the bonus payments arises only when the participants remain employed by it for the requisite amount of time after the merger. Thus, Taxpayer concludes that its obligation to distribute payments from the trust originates in its post-employment relationship with the participants. Conversely, the field contends that the operative transaction is Taxpayer’s obligation to fund the irrevocable trust, which arose solely because of the acquisition transaction negotiations and was inextricably tied to the transaction itself.

Based on the facts developed thus far, we agree with the field that the operative transaction is Taxpayer’s funding of the irrevocable grantor trust, not the subsequent distributions from that trust. The point at which the liability to fund the bonus plan arises, i.e., the origin of the transaction for which the expenditure is incurred, appears to be when Taxpayer entered into the acquisition transaction, not when the actual distributions to the participants are made. An analysis as to whether the payments relate to pre-acquisition or post-acquisition services, as discussed below, also is relevant to determine the character of the transaction, i.e., whether it arises in connection with the acquisition of future services of the participants as part of the acquisition of Target or as compensation for services rendered prior to the acquisition.

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Although we have not been provided with sufficient facts to reach a conclusion on this issue, many of the facts that have been provided indicate that the funding of the trust originated in the acquisition transaction. First, the bonus plan was established as a direct result of the negotiations which led to the acquisition transaction. It was so important to one, or both, parties that it was made a condition precedent to the closing of the transaction. Second, we note that the circumstances under which a participant's allocable share vests without continuing employment following the acquisition are quite extensive, which suggests, contrary to Taxpayer's assertion, that the bonus plan contributions were intended to be distributed regardless of the performance of future services. Further, the facts indicate that the parties agreed on a total price for the purchase of Target's stock and then divided that amount between the actual stock purchase and the funding of the employee bonus plan. As discussed above, the original agreement provided for a total aggregate price of \$h – \$a for the stock and \$b to fund the bonus plan. When the transaction closed, the purchase price for the stock was increased by \$g to \$f and the initial contribution to the trust was decreased by the same \$g to \$e, although the total aggregate price of \$h remained the same. (The second trust contribution also remained the same at \$d.) The fact that the aggregate purchase price remained the same while the individual figures for the stock purchase and initial trust contribution fluctuated suggests that the parties negotiated one total purchase price for the acquisition and then allocated a portion of the total consideration for the employee bonus plan.³ Finally, Target did not have a bonus plan in effect before the acquisition negotiations began, so Taxpayer's obligation to fund the plan was a new obligation arising solely from the acquisition transaction itself.⁴

Taxpayer cites several previous Technical Advice Memoranda involving severance plans and bonus plans in support of its argument that the post-acquisition employment relationship is the origin of its bonus plan contributions. There are significant differences between those situations and this case.

³ Taxpayer acknowledges that the price for the stock purchase was \$g higher than called for in the stock purchase agreement while the initial contribution was the same \$g lower, but does not provide an explanation for these differences.

⁴ Thus, the contributions appear to be additional consideration for Target's stock. We also note that the bonus plan arguably provided a significant future benefit to Taxpayer by encouraging Target's employees to remain employed by Taxpayer as an assembled workforce. Because Taxpayer continues to operate Target as an intact, unincorporated division, it reaps the benefit of the collective knowledge and working relationships of this assembled workforce, which constitutes a benefit lasting beyond the close of the taxable year of year 1.

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Compensation paid under severance plans principally relates to prior services, not services to be performed in the future. See Rev. Rul. 94-77, 1994-2 C.B. 19. Furthermore, in each of these other cases, the bonus plan or severance pay plan at issue pre-dated the acquisition transaction. The severance plans in TAM 9731001 and TAM 9721002, for example, existed before the acquisition negotiations began, and so the target's respective obligations to make severance payments had been undertaken at a previous time and were based on pre-acquisition employment relationships with plan participants. Here, Target did not have a pre-existing employee bonus plan. The bonus plan constitutes a new obligation generated by the merger transaction itself. Likewise, TAM 8641001 concludes that special bonuses triggered by an acquisition transaction were deductible because the bonus plan was pre-existing and the "special bonuses were not paid in satisfaction of a new obligation generated by the restructuring itself" (emphasis supplied). Here, the bonus plan was funded specifically because of a new obligation created by the merger transaction. Thus, the previous technical advices cited by Taxpayer involve different factual situations.

It is true that, under some circumstances, the participants only become vested in their shares by remaining employed by Taxpayer during the x years following the acquisition, and this vesting attribute creates a connection between the post-acquisition employment relationship and distribution of the vested amounts. However, we have not been provided with any information concerning how the amount of each participant's account was initially determined, or how the overall funding amount for the plan was determined. This issue is important because the size of a participant's account determines the amount of his or her bonus (assuming the participant meets the vesting requirements). If the size of the account has any relationship to an employee's past services or length of service with Target, then the distribution of vested amounts may arise in connection with pre-acquisition services, not post-acquisition services. As discussed above, the size of the participants' accounts varies greatly, from \$i to \$j. This wide range suggests that the bonuses were not intended solely as compensation for future services. Another factor to consider is whether the combined bonus and salary a particular participant receives constitutes reasonable compensation for the post-acquisition services rendered in a particular year.

Subject to the factual development concerns discussed above, it appears that the proposed treatment of the contributions to fund the employee bonus plan as capital expenditures, either as amounts paid as part of the purchase price of Target's stock or as consideration for a separate intangible asset, i.e., an assembled workforce, is appropriate. The next issue is how the amounts should be taken into account for tax purposes.

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Amortization

Section 197(a) provides for an amortization deduction with respect to any amortizable § 197 intangible. The amount of the deduction is determined by amortizing the adjusted basis of such intangible ratably over the 15-year period beginning with the month in which such intangible is acquired. Section 197(c)(1) provides, in part, that the term “amortizable § 197 intangible” means any § 197 intangible acquired after August 10, 1993, and held in connection with the conduct of a trade or business. Section 197(d)(1) provides that the term “section 197 intangible” means, in part, goodwill, going concern value, workforce in place, business books and records, any trademark or trade name, as well as any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. Section 197(f)(3) provides that any amount paid or incurred pursuant to a covenant or arrangement referred to in § 197(d)(1)(E) shall be treated as an amount chargeable to capital account.

Section 1.338(b)-2T (as amended by T.D. 8711, 1-9-97) provides rules under § 338(b)(5) for allocating the adjusted grossed-up basis (AGUB) among the assets of a target for which a § 338 election is made. Section 1.338(b)-2T(b) provides for allocation to five asset classes (Class I-V), with the AGUB first allocated to Class I, then to Class II, followed by Classes III and IV, with the residual (if any) to Class V. Class IV assets are defined as § 197 intangibles except those in the nature of goodwill and going concern value, and Class V assets are § 197 intangibles in the nature of goodwill and going concern value. Section 1.338(b)-2T(c)(1) provides that the amount allocated to an asset (other than Class V assets) shall not exceed the fair market value of that asset at the beginning of the day after the acquisition date.

If the \$b contribution to the Trust is determined to be included in the AGUB pursuant to § 338 and the regulations thereunder, and since the AGUB allocation had already reached Class V, then this amount would also be allocated to Class V and, therefore, would be subject to § 197 and amortized over the 15-year period. If, on the other hand, the contributions to the Trust are separately capitalized pursuant to § 263(a), then this amount would also be subject to amortization over the same 15-year period as an amortizable § 197 intangible. This latter result is applied since the expenditure and its long term benefits relate to the desire of the parties to the transaction to provide both a way to compensate the employees for their past contributions to the success of the business as well as provide Taxpayer with a method of retaining employees in place for a period of years to secure transfer of their knowledge and skills, and ensuring the success of the business. The bonus

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plan covered all Target's employees - providing an incentive to retain all employees as a workforce in place. Thus, the intangible asset would relate to workforce in place, which is defined under § 197(d)(1)(C)(i) as a § 197 intangible.

Other § 197 Issues

Although not specifically raised in the request for field service advice, there are also § 197 issues in this case relating to the non-compete covenants with the 15 nonshareholder employees and the personal service contracts.

As discussed above, § 197(d)(1) provides that the term "section 197 intangible" means, in part, any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with the acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof. Section 197(d)(1)(E). Section 197(f)(3) provides that any amount paid or incurred pursuant to a covenant or arrangement referred to in § 197(d)(1)(E) shall be treated as an amount chargeable to capital account.

The legislative history to § 197, in its discussion of covenants not to compete and other similar arrangements (H.R. Conf. Rep. No.213 103rd Cong. 1st Sess. 672 , 677 (1993)), provides that an arrangement that requires the former owner of an interest in a trade or business to continue to perform services that benefit the trade or business is considered to have substantially the same effect as a covenant not to compete to the extent that the amount paid to the former owner under the arrangement exceeds the amount that represents reasonable compensation for the services actually rendered by the former owner.

Accordingly, if any amount of the purchase price was paid or incurred to secure the non-compete covenants with the 15 officers and employees, this amount is to be included in Class IV assets and amortized over the 15-year period. Further, any amount paid in any taxable year to Executive A (a shareholder) under the 5-year personal services contract that exceeds the amount that represents reasonable compensation for the services actually rendered is required to be capitalized and amortized over the remaining portion of the original Class IV 15-year amortization period. If Executive B is also a shareholder, the same rule applies.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call _____ of my office at _____ if you have any further questions.

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