Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201713010**
Release Date: 3/31/2017

CC:ITA:B01:ALWarren
POSTU-127013-15

[Third Party Communication:
Date of Communication: <Month> DD, YYYY]

UILC: 263.00-00

date: December 20, 2016

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subject: Tax Treatment of Costs Satisfying a Regulatory Authority Condition for Approval of Merger

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
B	=
C	=
D	=
Company E	=
Subsidiary F	=
G	=
Year 1	=
Company H	=
City J	=
Regulatory Board	=

Date 1 =
Date 2 =
Date 3 =
Date 4 =
State K =
M =
Amount N =
Amount O =
Year 2 =
Amount P =
Date 5 =
Amount Q =
Amount R =
S =
Amount T =
U =
Date 6 =
V =

ISSUE

Section 1.263(a)-5(a) of the Income Tax Regulations (regulations) requires a taxpayer to capitalize an amount paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Where a regulatory agency approves a merger subject to certain conditions, are the costs of activities undertaken in satisfaction of the regulatory agency's conditions per se required to be capitalized under § 1.263(a)-5 as amounts paid to facilitate a transaction?

CONCLUSION

Where a regulatory agency approves a merger subject to certain conditions, the costs of activities undertaken in satisfaction of the regulatory agency's conditions are not per se required to be capitalized under § 1.263(a)-5 as amounts paid to facilitate a transaction.

FACTS

Taxpayer is a B holding company. Its subsidiaries include regulated C companies engaged in D. In Year 1, Taxpayer and Company E negotiated the basis for a merger. Company E owned, among other interests, a regulated C company, Company H. This proposed merger required the approval of Regulatory Board.

On Date 1, Taxpayer's Board of Directors approved the proposed merger. On Date 2, Taxpayer and Company E submitted their first application to Regulatory Board for approval. There were numerous submissions and hearings on the proposed merger during the following six months. In Date 3, Taxpayer and Company E entered into a

settlement with the State K, City J, and certain other interested parties in connection with the regulatory proceedings. On Date 4, Regulatory Board approved the merger subject to the following conditions:

1. An Amount N rate credit for each Company H customer. The rate credit reduced Company H's revenue by Amount O in Year 2. Taxpayer made an Amount P capital contribution to Company H to fund the rate credit. The rate credit was made to customers of record on Date 5.

2. An Amount Q contribution to a customer investment fund. The fund was set up to provide long-term benefits to Company H customers in the form of V.

3. Payments totaling Amount R to State K for development of an S.

4. A commitment to contribute Amount T per year for U to charitable organizations and traditional local community support within State K.

On Date 6, Company E was merged into Taxpayer in a stock for stock transaction. Company H became a wholly-owned subsidiary of Taxpayer.

LAW AND ANALYSIS

Section 162 of the Internal Revenue Code generally allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. However, § 263(a) provides that no deduction is allowed for any amount paid out for permanent improvements or betterments made to increase the value of any property.

Section 1.263(a)-5(a) of the regulations provides that a taxpayer must capitalize an amount paid to facilitate certain transactions, including "an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b)." Section 1.263(a)-5(a).

Section 1.263(a)-5(b)(1) of the regulations provides further clarification concerning when an amount is paid to facilitate a transaction:

> [A]n amount is paid to facilitate a transaction . . . if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative.

The preamble to the proposed regulations (67 F.R. 77701-01, 2003-1 C.B. 373), which first introduced the concept of costs that facilitate a transaction, provides further discussion concerning the relevance of the fact that an amount would not have been paid but for the transaction:

> The facilitate standard is intended to be narrower in scope than a "but for" standard. Thus, some transaction costs that arguably are capital under a but-for standard, such as costs to downsize a workforce after a corporate merger (including severance payments) or costs to integrate the operations of merged businesses, are not required to be capitalized under a facilitate standard. While such costs may not have been incurred but-for the merger, the costs do not facilitate the merger itself.

In requiring capitalization of the costs at issue, the examining agent appears to rely primarily on a but-for test to argue that the costs in question are capital expenditures under § 1.263(a)-5. The examining agent primarily relies on the conclusion that Taxpayer would not have incurred the costs at issue but-for the merger. While it would not be unreasonable to conclude that the costs at issue were incurred in order to obtain regulatory approval for the merger, the mere fact that costs would not have been incurred but for the closing of a transaction identified in § 1.263(a)-5(a) is not sufficient to determine that the costs facilitate the transaction.

As noted in the preamble to the proposed regulations, the facilitate standard is meant to be narrower than a but-for standard. Section 1.263(a)-5(b) explains that costs are facilitative if they are incurred in "investigating or otherwise pursuing" the transaction. The costs specifically identified as facilitative in § 1.263(a)-5 are "deal costs," that is, amounts paid to service providers, such as investment bankers, attorneys, and transfer agents, who undertake financial, legal, investigatory, or administrative activities that are generally provided exclusively for the purpose of pursuing a transaction but which otherwise are not general operating costs of the target or acquirer. See § 1.263(a)-5(l), ex. 1, 2 & 3.

Not all costs incurred because of a merger are facilitative for purposes of § 1.263(a)-5. For example, the purchase price is not facilitative, nor is an amount paid to another party in exchange for tangible or intangible property. See § 1.263(a)-5(b)(1). In addition, as noted in the preamble to the proposed regulations, costs to downsize a workforce after a corporate merger or costs to integrate the operations of merged businesses also are not facilitative.

In this case, we do not have sufficient information to determine whether Taxpayer incurred the costs at issue solely on account of the merger. However, most of the costs identified are in the nature of annual operating costs that a M company would incur as part of its normal business operations. For example, regulators commonly require M companies to charge set amounts to customers or provide customers with various

credits. Additionally, M companies frequently make annual contributions to charitable organizations or for local community support.

In the case of the costs identified that may not be in the nature of annual operating costs, the payments to State K for the development of an S, while not entirely clear, it appears that the taxpayer may receive the right to intangible property as a result of the payment. As noted above, under § 1.263(a)-5(b)(1), an amount paid to another party in exchange for intangible property is not an amount paid to facilitate a merger.

The examining agent sets forth an alternative argument based on the fact that § 1.263(a)-5(e)(2)(iv) lists "obtaining regulatory approval" as an amount paid that is "inherently facilitative." Under § 1.263(a)-5(e)(2)(iv), obtaining regulatory approval includes "preparing and reviewing" regulatory filings. It also includes attorneys' fees to defend against lawsuits filed by regulators to halt a transaction, even if those fees are incurred after the transaction is completed. See § 1.263(a)-5(l), ex. 10. The examining agent asserts that because Regulatory Board was required to approve the proposed merger and ordered Taxpayer to pay the costs in question as a condition to its approval, these costs are included with the costs incurred in obtaining regulatory approval.

The costs of obtaining regulatory approval include the costs of preparing for and appearing before a regulatory board. The phrase "regulatory approval" should not be read so broadly that it includes any and all costs to address conditions that might be imposed by regulators.

In this case, the costs at issue appear to be in the nature of annual operating or investment expenses and not analogous to deal costs paid to service providers who assist with financing, investigating, documenting, or otherwise administratively facilitating the transfer of property. As noted above, three of the four costs are commonly and frequently required by regulators and are annually incurred by M companies as part of their ordinary and recurring business operations. In addition, the fact that Company E was previously making annual donations in the same amount as Company E's commitment to make future donations suggests a continuation of Company E's prior business practice. Finally, as noted previously, the fourth cost appears to be, at least in part, in exchange for intangible property.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Angella Warren at (202) 317-7003 if you have any further questions.

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