Office of Chief Counsel
Internal Revenue Service

memorandum

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KSChaberski

date: December 5, 2000

to: Revenue Agent Rhonda Winter (LMSB, Group 1267)
Knoxville, Tennessee

from: Associate Area Counsel, (LMSB) Area 3 - Nashville

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subject: [redacted]
EIN: [redacted]
[redacted]
Cycle: [redacted]
Advisory Opinion

This is in response to your inquiry regarding the above-referenced taxpayer's claimed deduction, as ordinary and necessary business expenses, of compensation paid to two corporate executives. The amount at issue with respect to this issue is the percentage of each executive's annual salary and bonus which corresponds to the percentage of time which each officer spent during the year on three separate business transactions in which the taxpayer participated during the year under examination; a merger, a stock acquisition, and an initial public offering of the taxpayer's common stock.

ISSUE

Whether the portion of the compensation paid by the taxpayer to two separate corporate executives which has been allocated to work done by those individuals relating to a merger, an acquisition, and an initial public offering during the year under examination should be segregated from the remaining compensation and capitalized with the other costs relating to each such transaction under I.R.C. § 263 or deducted currently along with the rest of the compensation as an ordinary and necessary business expense under I.R.C. § 162?

CONCLUSION

We believe that all of the compensation paid to these two executives was properly deducted by the taxpayer on the return under examination. In our opinion, the compensation, which was paid in accordance with employment agreements which predate and are unrelated to the three capital transactions, is an ordinary and necessary business expense of the taxpayer and is thus subject to deduction during the year incurred and paid in accordance with I.R.C. § 162.

FACTS

[redacted] (hereinafter "the taxpayer"), is a bank holding company which you are currently examining for the taxable year ended [redacted]. During your examination, you have determined that the taxpayer participated in three major capital transactions during the year. These transactions dramatically changed the holdings and organizational structure of the taxpayer. The first such transaction was the acquisition by the taxpayer, during [redacted], of [redacted]% of the outstanding stock of [redacted]. The second such transaction was a merger, which closed in [redacted], with [redacted]. This merger, in which [redacted] shareholders received [redacted] shares of the taxpayer's stock in exchange for each share of [redacted] stock, constituted a corporate reorganization under I.R.C. § 368(a)(1)(A). The final transaction relevant to this memorandum was an initial public offering ("IPO") of the taxpayer's shares on the NASDAQ National Stock Exchange, which took place on [redacted]. During September [redacted], the taxpayer received net proceeds from the IPO in an amount of approximately $[redacted].

The Service and the taxpayer agree that the taxpayer's President, as well as it's Chief Financial Officer (hereinafter referred to collectively as "the executives" or "the employees"), performed services during [redacted] which were related to and in preparation for each of the above-referenced capital transactions.[1] The Service and the taxpayer also agree that the following table indicates an allocation of these executives' compensation (salary and bonus) based upon the time each devoted

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[1] Similar services were performed by those two executives on behalf of the taxpayer during the [redacted] taxable year with respect to a prior merger in which the taxpayer was involved in [redacted]. During the Service's examination of the prior cycle (which included the [redacted] year), the taxpayer agreed that the portion of compensation paid to each of those individuals which was allocated to the services performed in preparation for the [redacted] merger (in the total amount of $[redacted]) should be capitalized as a cost of the merger. As is further explained below, the taxpayer now believes that they improperly conceded this adjustment, though they apparently do not now seek to contest that concession as relates to the prior cycle.

during [redacted] to each respective transaction:

[redacted] IPO

Officer	Annual Salary	Bonus	Total	Amount Allocated to IPO
President	[redacted]	[redacted]	[redacted]	$ [redacted]
Chief Financial Officer	[redacted]	[redacted]	[redacted]	[redacted]
Total	$[redacted]	$[redacted]	$[redacted]	$ [redacted]

[redacted] Acquisition

Officer	Annual Salary	Bonus	Total	Amount Allocated to Acquisition
President	[redacted]	[redacted]	[redacted]	$ [redacted]
Chief Financial Officer	[redacted]	[redacted]	[redacted]	$ [redacted]
Total	$[redacted]	$[redacted]	$[redacted]	$ [redacted]

[redacted] Merger

Officer	Annual Salary	Bonus	Total	Amount Allocated to Merger
President	[redacted]	[redacted]	[redacted]	$ [redacted]
Chief Financial Officer	[redacted]	[redacted]	[redacted]	$ [redacted]
Total	$[redacted]	$[redacted]	$[redacted]	$ [redacted]

There is no reason to believe that the above-reflected salaries and bonuses are not reasonable or that any of those amounts were determined based upon either executive's participation in any of the three previously discussed capital transactions. In fact, it is clear that each of these executives would have received this compensation in accordance with his respective employment contract even if the taxpayer had not entered into one or more of these transactions.

The taxpayer has claimed a current deduction for the entire amount of salary and bonus paid to each of these executives during the year at issue. The Service believes that the portion of the salary and bonus which are properly allocated to the capital transactions (in the aggregate amount of $[redacted] as indicated in the above table) constitute capital expenditures which are directly related to each of these transactions. The Service thus proposes to disallow $[redacted] of the taxpayer's claimed deduction for compensation paid to employees under I.R.C. § 263.

DISCUSSION

I.R.C. § 162(a) allows a current deduction for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." To qualify for a deduction under Section 162(a), an item must be (1) paid or incurred during the taxable year (2) paid or incurred for carrying on of any trade or business, (3) an expense, (4) a "necessary" expense, and (5) an "ordinary" expense. Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971). In order to qualify as "ordinary", an expense must relate to a transaction "of common or frequent occurrence in the type of business involved." Deputy v. Du Pont, 308 U.S. 488, 495(1940).

In contrast, I.R.C. § 263 allows no current deduction for a capital expenditure. A capital expenditure is defined as, inter alia, "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." I.R.C. § 263(a)(1). If an expense constitutes a capital expenditure, it is not currently deductible; rather, the expenditure is usually amortized and depreciated over the life of the asset to which it is connected. When no specific asset or useful life can be ascertained, the expense can be recovered only upon dissolution of the business enterprise. See, I.R.C. §§ 167(a) and 336(a).[2] Under section

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[2] We note that the expenses here at issue could conceivably be considered as "start-up expenditures". If so, these expenses

263, an expenditure which "serves to create or enhance...a separate and distinct" asset must be capitalized rather than claimed as a current deduction under section 162(a). INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).

Relevant to the inquiry of whether a particular expense is subject to immediate deduction or capitalization is the duration and extent of benefits realized by the taxpayer from said expense; a taxpayer's realization of benefits beyond the year in which the expenditure is incurred, while not in and of itself determinative, is important in determining the appropriate tax treatment. INDOPCO, Id.

Courts have long recognized that expenses which are incurred for the purpose of changing a corporate structure or for the benefit of future operations are not ordinary and necessary business expenses, rather, expenses directly related to such activities must be capitalized. INDOPCO, 503 U.S. at 86, citing General Bancshares Corp. v. Commissioner 326 F. 2d 712, 716 (8th Cir. 1964), cert. denied, 379 U.S. 832 (1964). On the other hand, paying a salary and or bonus to a corporate executive in exchange for services rendered is clearly a transaction "of common or frequent occurrence", leading to a current deduction under section 162. See, e.g., Wells Fargo & Company v. Commissioner, 86 AFTR 2d ¶ 2000-5217 (8th Cir. August 29, 2000).

The expenses about which you inquire are compensation paid to employees in exchange for services rendered in changing the taxpayer's corporate structure. Thus, your inquiry provides a clear example of the tension between these two principles. The Supreme Court held, in INDOPCO, that expenses paid to outside professionals (accountants, lawyers, etc.) for their assistance

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could be claimed as an amortized deduction (prorated equally over a period of not less than 60 months) in accordance with I.R.C. § 195. In general, to qualify for amortization under Section 195 the expenditure must be one that is paid or incurred in connection with (1) investigation the creation or acquisition of an active trade or business, (2) creating an active trade or business, or (3) true start-up costs for a new business if the expenses would be allowed as a deduction had they been paid or incurred in connection with the operation of an existing trade or business. We note that amortization of the expenses at issue Section 195 is not available here since the taxpayer has failed to make a required election (which must be made on or before the date on which the return is due). I.R.C. § 195(d)(1). Thus, if the taxpayer is not entitled to deduct the expenses here at issue, those expenses must be added to the taxpayer's basis in the asset to which each such expense relates.

in a corporate acquisition were directly related to the acquisition and thus must be capitalized rather than currently deducted. Following the Supreme Court's decision in the INDOPCO case, the Service (as well as the Tax Court and many taxpayers) often took the position that **any** costs incurred by a taxpayer which were related to corporate acquisitions and reorganizations were directly related to a future benefit and thus must be capitalized rather than deducted. This line of thinking was eventually applied not only to expenses paid to outside professionals, but also to compensation paid by the taxpayer to its employees for work relating to the capital transaction. This necessitated analysis and apportionment of compensation between capital transactions and other duties, as is reflected in the table above for the instant case.

In Norwest Corp. & Subsidiaries v. Commissioner, 112 T.C. 89 (1999), the Service claimed that the portion of the salaries paid to corporate executives for their involvement in a corporate merger/acquisition must be capitalized as part of the cost of the acquisition rather than currently deducted. The Tax Court agreed. However, the Eighth Circuit Court of Appeals reversed, finding that the salaries were ordinary and necessary business expenses which were subject to current deduction in accordance with I.R.C. § 162. Wells Fargo & Company v. Commissioner, 86 AFTR 2d ¶ 2000-5217 (8th Cir. August 29, 2000).

In Wells Fargo (which is the appellate opinion in the Norwest case), the Eighth Circuit focused on the relationship between the expenses at issue and the long term benefit provided to the taxpayer by the capital transaction. The Court found that the salaries at issue in that case (which, as in the instant case were not determined by the employee's participation in the merger) were only indirectly related to the capital transaction. The Eighth Circuit, citing several Technical Advice Memoranda and Private letter Rulings which had previously been issued by the Service, stated that "payments made by an employer are deductible when they are made to employees, are compensatory in nature, and are directly related to the employment relationship (and only indirectly related to the capital transaction which provides the long term benefit)." Thus, unlike the **payments to outside parties** for work on a merger in the INDOPCO case (which the Supreme Court determined must be capitalized), the **employee compensation** at issue in Wells Fargo was currently deductible.

The Service has neither acquiesced nor issued a declaration of non-acquiescence to the Wells Fargo opinion. Thus, we have discussed this case with our national office. They agree with this office that, based upon the facts of this particular case, the compensation at issue is currently deductible. This conclusion is based upon several factors, all of which we believe strongly support current deductibility of the salaries and bonuses at issue in this case. First, the employment relationship between the taxpayer and each of these executives was long-term, ongoing, and unrelated to these capital transactions; this was not a situation where the employees were hired specifically to perform services directly related to those transactions. Second, the compensation here at issue would have been paid to both of the employees regardless of whether the capital transactions had occurred; the compensation paid to each was reasonable for similarly situated bank executives not involved in transactions of this type and was in no way enhanced by their participation in these transactions. Finally, neither of these employees spent significant amounts of time on the three capital transactions; analysis of the agreed compensation apportionment indicates that the two executives spent a total of about 7% of their compensated time during the year on all three of these transactions in the aggregate.

Under these circumstances, we believe it is clear that the compensation paid to the two executives is an ordinary and necessary business expense. Thus, we believe that disallowance of the portion of the compensation attributable to the capital transactions would not be upheld if this case is ultimately litigated. We thus recommend that the deduction be allowed as claimed.

Our conclusion in this case does not indicate that we believe that salary and/or bonus which is related in some manner to a capital transaction is always subject to current deduction. For example, we believe that the compensation paid to "employees" who are hired for the specific purpose of participating in a capital transaction may not, in some cases, constitute an ordinary and necessary business expense. Similarly, a bonus which is based solely upon an employee's significant participation in a capital transaction may be subject to capitalization rather than current deduction. The Service must consider these issues on a case-by-case basis, making a determination in each case on the relationship (direct or indirect) of the expense to the capital transaction.

This memorandum contains privileged information. Any unauthorized disclosure of this memorandum will have an adverse effect on privileges, including the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

Please feel free to contact the undersigned at (615) 250-5598 if you have any questions on the above advice or if you wish to discuss this matter further.

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