INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 23, 2005

Number: **200548022**
Release Date: 12/2/2005

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 162.14-00
CASE-MIS No.: TAM-122482-05/CC:ITA:B01

Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Parent =
Year A =
Year B =
Year Z =
Corp A =
Corp B =
Corp C =
Corp D =
Firm E =
Firm F =
Firm G =
Firm H =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

Date 6	=
Date 7	=
Date 8	=
Date 9	=
Month 1	=
$a	=
$b	=
w%	=
x%	=
y%	=
z%	=
X	=
Z	=

ISSUE(S):

(1) Does Taxpayer's filing of an informal claim to currently deduct under § 162 of the Internal Revenue Code the entire amount of certain fees for which a § 195[1] election had been made and attendant amortization deductions had been taken on the original returns, constitute a change in method of accounting for which Taxpayer was required to obtain the advance consent of the Commissioner under § 446(e)?

(2) Do the financial services fees and investment banker fees incurred by Corp A and Corp B in anticipation of being acquired by Taxpayer qualify as start-up expenditures that can be amortized under § 195 on Taxpayer's consolidated federal income tax return?

(3) Are the financial services and investment banker fees incurred by Corp A and Corp B in anticipation of being acquired by Taxpayer allocable to Corp A's and Corp B's final federal income tax returns, respectively, or are they allocable to Taxpayer's consolidated federal income tax return?

CONCLUSION(S):

(1) Taxpayer's claim to currently deduct amounts for which a § 195 election had been made on its original return constitutes a change in method of accounting for which Taxpayer was required to obtain the advance consent of the Commissioner.

(2) The financial services and investment banker fees incurred by Corp A and Corp B do not qualify as start-up costs that can be amortized under § 195 on Taxpayer's consolidated return.

[1] All references to § 195 are to provisions under § 195 in effect prior to amendments effective October 22, 2004, under the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

(3) The financial services and investment banker fees incurred by Corp A and Corp B are allocable to Corp A's and Corp B's final federal income tax returns, respectively. Any financial services and investment banker fees incurred by Taxpayer with respect to any of the three acquisitions are allocable to Taxpayer's consolidated return for the year at issue.

FACTS:

Taxpayer, a consolidated group of corporations,

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In Year A, Parent, the parent corporation of Taxpayer, acquired Corp A and Corp B (collectively, the "Target Corporations") through transactions structured to qualify as reorganizations under § 368(a)(1)(A) and (2)(E). Parent also acquired substantially all the assets of Corp C in Year A.

<u>Corp A acquisition</u>

On Date 1, Corp A engaged Firm E and Firm F to provide financial advice and assistance in connection with a proposed sale of Corp A to Corp D. On Date 2, the engagements with Firm E and Firm F were broadened to include financial advice and assistance in connection with the potential sale of Corp A to parties other than Corp D.

Pursuant to the terms of the engagement letter, the financial services and investment banker fees payable to Firm E and Firm F were dependent on the outcome of the assignment. If the sale of Corp A was accomplished, Firm E and Firm F would receive a $a transaction fee in the aggregate upon closing of the transaction, with w% payable to Firm E and x% payable to Firm F.

On Date 3, the Corp A Board of Directors approved the acquisition of Corp A by Parent. On Date 4, a newly-created and wholly-owned subsidiary of Parent was merged with and into Corp A, with Corp A as the surviving legal entity. For federal income tax purposes, Corp A's pre-acquisition taxable year ended on Date 4, and Taxpayer's taxable year ended on Date 5. Corp A did not deduct on its final tax return the transaction fees paid to Firm E and Firm F. Corp A had a net operating loss that was subject to § 382 limitations on its final tax return.

<u>Corp B acquisition</u>

On Date 6, Corp B and Firm G signed a formal engagement letter providing for Firm G to render financial advisory and investment banking services to Corp B in connection with a possible business combination of Corp B and another corporation or business entity. Pursuant to the engagement letter, Corp B agreed to pay Firm G, (i) if there was a public announcement by Corp B that it had entered into an agreement to sell the company, a fee in an amount equal to x% of the transaction fee that would be payable at the time of the consummation of the sale transaction and (ii) upon consummation of the sale transaction, the greater of a stated percentage of the value of the transaction or $b, reduced by any fee paid upon the public announcement.

On Date 7, the Corp B Board of Directors approved the acquisition of Corp B by Parent. On Date 8, a newly-created and wholly-owned subsidiary of Parent was merged with and into Corp B, with Corp B as the surviving legal entity. Corp B shareholders received in exchange for their common stock in Corp B, and Corp B became a wholly-owned subsidiary of Parent. For federal income tax purposes, Corp B's pre-acquisition taxable year ended on Date 8. Taxpayer's taxable year ended on Date 5. Corp B did not deduct any of the transaction fees on its final tax return.

<u>Taxpayer's original treatment of costs related to the Corp A and Corp B acquisitions</u>

On its Year A consolidated federal income tax return, Taxpayer elected § 195 treatment for z% of the fees paid to Firm E and w% of the fees paid to Firm F, as well as for legal, consulting, accounting, and other costs incurred by Corp A up to Date 3. Taxpayer also elected § 195 treatment for y% of the fees paid to Firm G and for other financial services, legal, consulting, accounting, and other costs incurred by Corp B up to Date 7. Finally, Taxpayer elected § 195 treatment for financial advisory fees and legal, consulting, accounting, and other costs incurred by Taxpayer with respect to the Corp A and Corp B acquisitions up to Date 3, and Date 7, respectively. Taxpayer deducted amounts for amortization of all costs for which a § 195 election was made on its Year A and Year B tax returns. During the Internal Revenue Service's examination of Taxpayer's Year A and Year B tax returns, Taxpayer filed an informal refund claim, contending that the entire amount characterized as start-up costs on its Year A tax return was currently deductible under § 162. Taxpayer asserts that these costs were for pre-decisional or investigatory activities related to an expansion of an existing trade or business. Taxpayer did not file a Form 3115, Application for Change in Accounting Method, requesting consent to change its treatment of these costs.

The financial services and investment banker fees incurred by Target Corporations were success-based fees and were not directly related to hours worked or services provided. The percentages of the fees claimed by Taxpayer to be deductible as pre-decisional or investigatory costs are based on letters prepared by the investment bankers in Year B in response to requests by Taxpayer's accountants. The percentages stated in the letters are estimates of the percentages of time spent on pre-decisional and investigatory services by the investment bankers in Year A and the previous year. The letters state that the investment bankers do not maintain records of the amount of time spent on specific services through the course of a transaction and that the stated allocations of time spent are good faith estimates only. Several of the letters indicate that the estimates involved significant elements of subjective judgment as well as certain arbitrary assumptions and include a disclaimer as to accuracy or completeness of the information.

Corp C asset acquisition

On Date 9, Taxpayer engaged Firm H to act as Taxpayer's financial advisor in connection with the acquisition of all or a portion of the stock or assets of Corp C. During Month 1, Year A, Parent acquired substantially all of the assets of Corp C. Taxpayer elected to treat the financial advisory, legal, accounting, and other fees and expenses incurred by Taxpayer in relation to the Corp C asset purchase as start-up costs under § 195 on Taxpayer's Year A consolidated federal income tax return. Taxpayer deducted amounts for amortization of these costs on its Year A and Year B tax returns. During the Service's examination of Taxpayer's Year A and Year B tax returns, Taxpayer filed an informal refund claim, contending that the entire amount characterized as start-up costs on its Year A tax return was currently deductible under § 162. Taxpayer asserts that these costs were for pre-decisional or investigatory activities related to an expansion of an existing trade or business. Taxpayer did not file a Form 3115, Application for Change in Accounting Method, requesting consent to change its treatment of these costs.

LAW AND ANALYSIS:

ISSUE 1

Section 446(a) provides that a taxpayer's income is to be computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping its books. *See also* § 1.446-1(a)(1) of the Income Tax Regulations. Generally, a taxpayer that changes the method of accounting on the basis of which it regularly computes income in keeping its books shall, before computing taxable income under the new method, secure the consent of the Secretary. Section 446(e). Consent must be secured whether or not the new method is proper or is permitted under the Internal Revenue Code or the regulations thereunder. Section 1.446-1(e)(2)(i). For procedures to obtain the consent of the Commissioner to change a method of accounting for federal income tax purposes, see Rev. Proc. 97-27, 1997-2 I.R.B. 11 (as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432) and Rev. Proc. 2002-9, 2002-1 C.B. 327 (as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002- 54, 2002-2 C.B. 432).

A change in accounting method does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, a change from treating an item as a personal expense to treating it as a business expense is not a change in method of accounting because it does not involve the proper timing of an item of income or deduction. Section 1.446-1T(e)(2)(ii)(b).

There is no exception to the method change provisions in § 446(e) for "recharacterization" of an item. *See Cargill Inc. v. United States*, 91 F. Supp. 2d 1293 (D. Minn. 2000). A change in the characterization of an item constitutes a change in method of accounting if the change has the effect of shifting income from one period to another. For example, in *Sunoco, Inc. v. Commissioner*, T.C. Memo 2004-29, the taxpayer sought to change the way it treated its overburden costs in connection with mining operations. Under its old method of accounting, it accounted for overburden costs as mine development costs. This allowed the taxpayer to deduct approximately 80% of the costs in the year they were incurred under § 616(a) and amortize the remaining costs over five years under § 291(b)(1) and (2). The taxpayer sought to change the way it treated its overburden costs by "recharacterizing" those costs as production costs so that the costs would be recovered through cost of goods sold. The issue was whether the taxpayer's change in treatment of its overburden costs was a change in method of accounting. The court held that the change was a change in method of accounting because it affected when the taxpayer would be able to recover the costs. The fact that the Code dictated how the reclassified costs were to be treated was irrelevant.

Section 1.446-1(e)(2)(ii)(a) provides that a change in method of accounting does include a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any "material item." A material item includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." *Id.* In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. *See Knight Ridder v. United States*, 743 F.2d 781 (11th Cir. 1984); *Peoples Bank & Trust Co. v. Commissioner*, 415 F.2d 1341, 1344 (7th Cir. 1969); *Primo Pants Co. v. Commissioner*, 78 T.C. 705, 723 (1982); Section 2.01(1) of Rev. Proc. 97-27; section 2.01(1) of Rev. Proc. 2002-9; Rev. Proc. 91-31, 1991-1 C.B. 566.

Section 1.446-1T(e)(2)(ii)(d)(2) specifically provides that a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting.

If a taxpayer's treatment of an item is a method of accounting, § 446(e) and § 1.446-1(e)(3) preclude the taxpayer from making a retroactive change in method of accounting by amending prior tax returns without the consent of the Commissioner. Rev. Rul. 90-38, 1990-1 C.B. 57. In this case, Taxpayer elected to amortize certain fees incurred by Taxpayer and Target Corporations and treat them as "start-up" expenditures under § 195.[2] Section 195 provides generally that a taxpayer may amortize (as a deferred

[2] Whether the costs at issue are actually "start-up" expenditures is irrelevant. The fact that Taxpayer

expense) its start-up costs over a period of not less than 60 months. In Year A and Year B, Taxpayer deducted portions of its overall start-up expenditures as provided in § 195. Taxpayer then attempted to change the way it treated those costs by filing an informal refund claim for Year A.

Taxpayer's change does not fall within one of the types of changes that are not changes in method of accounting. Taxpayer's change does not involve a mathematical or posting error; a change occasioned by the continued application of the same method to new facts; or any other change that is not treated as a change in method of accounting. *See* § 1.446-1(e)(2)(ii)(B).

Taxpayer's treatment of the costs at issue is a material item because it involves the proper time for taking of a deduction and it does not permanently affect taxpayer's lifetime taxable income. In this case, Taxpayer's original treatment would have resulted in Taxpayer recovering the costs at issue (via deductions) over 60 months. Under its new method, the full amount of the costs at issue was deducted in one year. Therefore, this is an issue of timing and not lifetime income.

Taxpayer's change does involve the recharacterization of expenditures from § 195 start-up costs to § 162 trade or business expenses. This recharacterization only affects the timing of deductions, and has no permanent impact on Taxpayer's lifetime taxable income. Accordingly, the recharacterization at issue in this case constitutes a change in method of accounting.

Because Taxpayer sought to change the way it treated a material item, it was required to secure the advance consent of the commissioner. However, Taxpayer never filed a Form 3115, Application for Change in Method of Accounting, to change its method of accounting for start-up costs; instead, it made an informal claim to change its method of accounting retroactively and without the consent of the Commissioner. This type of method change is not permissible.

<u>ISSUE 2</u>

Section 195(a) provides that except as otherwise provided in § 195, no deduction is allowed for start-up expenditures. Section 195(b) provides that start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses are allowed as a deduction prorated equally over a period of not less than 60 months as may be selected by the taxpayer (beginning in the month the active trade or business begins).

Section 195(c)(1) defines start-up expenditures, in part, as any amounts paid or incurred in connection with investigating the creation or acquisition of an active trade or business and, which, if paid or incurred in connection with the operation of an existing

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treated them as such is relevant.

active trade or business in the same field would be allowable as a deduction for the taxable year in which paid or incurred. Start-up expenditures, however, do not include any amounts that may be deducted under § 163(a), 164, or 174.

The costs incurred by Target Corporations during the process of deciding whether to be acquired do not meet the definition of start-up expenditures under § 195 because these expenses were not incurred in connection with Target Corporations' investigating the creation or acquisition of an active trade or business.

Further, § 195(c)(1) provides that expenses qualify as start-up expenditures only if they would be deductible for the taxable year in which they are paid or incurred in connection with the operation of an existing active trade or business in the same field. The costs incurred by Target Corporations will not satisfy this requirement if they are capital expenditures under § 263. Even if the expenses are currently deductible, they would not be start-up expenditures because § 195 does not apply to expenses incurred by an existing active trade or business that are, in fact, currently deductible by that business. Taxpayer asserts, and the examination team does not dispute, that the costs incurred by Taxpayer were incurred in connection with the expansion of an existing active trade or business.

Accordingly, the pre-decisional financial services fees and other costs associated with the transactions that were incurred by Target Corporations, do not qualify as start-up expenditures under § 195 and may not be amortized on Taxpayer's consolidated return.

<u>ISSUE 3</u>

Section 1.1502-76(b) describes the general rule regarding the items to be included in the consolidated return and provides that the consolidated return must include the common parent's items of income, gain, deduction, loss, and credit for the entire consolidated return year and each subsidiary's items for the portion of the year for which it is a member. If the consolidated return includes items of a corporation for only a portion of the tax year, items for the portion of the year not included in the consolidated return must be included in a separate return.

To determine the day on which a corporation becomes or ceases to be a member, § 1.1502-76(b)(1)(ii)(A) describes the end of the day rule, which provides that, if a corporation becomes or ceases to be a member during a consolidated return year, it becomes or ceases to be a member at the end of the day on which its status as a member changes, and its tax year ends for all federal income tax purposes at the end of that day.

Section 1.1502-76(b)(1)(ii)(B) describes the next day rule, which provides that if, on the day the corporation has a change in status as a member, a transaction occurs that is properly allocable to the portion of the corporation's day after the event resulting in the change, the corporation and all related parties under § 267(b) immediately after the event must treat the transaction for all federal income tax purposes as occurring at the beginning of the following day. A determination as to whether a transaction is properly allocable to the portion of the corporation's day after the event will be respected if it is reasonable and consistently applied by all affected persons. This subsection also enumerates some of the factors among those to be considered in determining whether an allocation is reasonable. Section 1.1502-76(b)(1)(ii)(B)(3)) describes one factor to consider as whether the allocation is inconsistent with other requirements under the Code.

Under the end of the day rule, each of the Target Corporations will be considered a member of Parent's consolidated group at the end of the day of each respective corporation's acquisition. For federal income tax purposes, the Target Corporations each will file a separate return for its respective short year, ending on the respective acquisition date, that will account for any items of income, gain, deduction, loss and credit. The financial services and investment banker fees incurred by Corp A and Corp B (the "Target Fees") are such an item that should be included in this short-year separate return, since they were incurred and the services were rendered either prior to, or on, the respective acquisition date, and the Target Corporations were the parties who benefited from the services. Assuming all other requirements for deductibility are met, the Target Fees should be deductible by the Target Corporations.

Taxpayer's informal claim that a portion of the Target Fees are deductible under § 162 is based on the characterization of those fees as "pre-decisional investigatory" costs incurred in connection with the expansion of an existing trade or business. Rev. Rul. 99-23, 1999-1 C.B. 998, provides guidance concerning which investigatory costs incurred in connection with the acquisition of a new trade or business are eligible for amortization as start-up expenditures under § 195. In the ruling, the Service explained that under § 195(c)(1)(B), expenditures described in § 195(c)(1)(A) that are incurred before the establishment of an active business are deemed to be paid or incurred in the operation of an existing trade or business (in the same field as the business the taxpayer is investigating whether to create or acquire). However, because § 195(c)(1)(B) also requires that an expenditure would be otherwise allowable as a deduction for the taxable year in which paid or incurred, the expenditure still must meet all the other requirements of § 162. Accordingly, the expenditure must be an ordinary expense under § 162 and not a capital expenditure under § 263 to be considered a start-up expenditure under § 195.[3]

[3] 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. *See also* § 1.162-1. However, § 263(a) provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. *See also* § 1.263(a)-1 and -2. We do not address § 1.263(a)-5 (regarding capitalization of amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions) in this memorandum because that regulation only applies to amounts paid or incurred on or after December 31, 2003. Section 1.263(a)-5(m).

Rev. Rul 99-23 holds that expenditures incurred in the course of a general search for, or investigation of, an active trade or business in order to determine whether to enter a new business and which new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation) qualify as investigatory costs that are eligible for amortization as start-up expenditures. However, expenditures incurred in connection with the attempt to acquire a specific business do not qualify as start-up expenditures because they are acquisition costs under § 263. The ruling further states that the nature of a cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the "*whether* and *which"* decisions, or an acquisition cost incurred to facilitate consummation of the acquisition.

The Eighth Circuit has applied the analysis used in Rev. Rul. 99-23 in determining the deductibility of a target corporation's investigatory costs incurred in connection with a corporate consolidation. *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *aff'g in part and rev'g in part Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999). The Tax Court held that the investigatory costs were required to be capitalized even though they were incurred before the decision to consolidate was made because they were sufficiently related to an event that produced a significant long-term benefit. After the publication of Rev. Rul. 99-23, the Service conceded on appeal the deductibility of legal expenses attributable to the "investigatory stage" of the transaction. *Wells Fargo*, 224 F.3d at 889. The Eighth Circuit agreed that any investigatory expenses that post-dated the "final decision" to consolidate should be capitalized. *Id.*

Taxpayer claims that the final decisions to go forward with the acquisitions of Corp A and Corp B were made on the dates each corporation's board of directors formally approved the transaction, or Date 3 and Date 7, respectively. Therefore, Taxpayer argues, any portion of the Target Fees incurred up to Date 3, with respect to the Corp A acquisition, and Date 7, with respect to the Corp B acquisition, are deductible investigatory costs. The examination team, while not conceding that the final decisions were made on Date 3, and Date 7, has not disputed the choice of dates. Accordingly, we assume, without deciding, that the "final decisions" were made on these dates.

Taxpayer argues under the next day rule that the Target Fees should be allocable to the portion of each Target Corporation’s day after the sale occurred and, thus, should be an item that Parent would take into account on its consolidated return. However, this treatment would be inconsistent with Taxpayer’s argument that a percentage of the Target Fees were incurred prior to the acquisitions and are attributable to investigatory activities conducted prior to the "final decision" dates. Furthermore, Taxpayer’s informal claim that a portion of the Target Fees should be currently deductible by Taxpayer as an ordinary and necessary business expense incurred in the expansion of an existing trade or business is also inconsistent with other requirements of the Code. If the Target Fees are related to the post-transactional period, then it appears that they would be capital in nature under § 263(a) and an acquisition cost incurred to facilitate consummation of the acquisition, not an investigatory cost. Therefore, assuming, without deciding, that

Taxpayer's characterization of the Target Fees as pre-decisional and investigatory is correct, the Target Fees are allocable to each of the Target Corporations' final federal income tax returns and are not deductible under § 162 on Taxpayer's consolidated return.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.