Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-2381-00
YMPeters

date: MAY 31 2000

to: Brian Bomar, Team Coordinator
CE 1104, San Marcos

from: Associate District Counsel, Southern California District, San Diego

---

subject: [redacted] - TLN 2381-00
Tax Treatment of Corporate Takeover Defense Costs

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to the attorney-client and deliberative process privileges and, if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to persons beyond those specifically indicated in this statement or to taxpayers or their representatives.

This advice is not binding on the Internal Revenue Service and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memo responds to your memorandum dated April 12, 2000, regarding the tax treatment of expenditures incurred in creating a "poison pill" as well as other expenditures paid to reduce [redacted]'s vulnerability to a possible, but not yet threatened, hostile (inadequate) takeover.

ISSUES

Whether the costs associated with [redacted]'s adoption of a shareholder rights plan should be capitalized.

CONCLUSIONS

Because the implementation of a shareholder rights plan alters the ownership of the corporation, it is a capital transaction. Expenses incurred in connection with the creation and

adoption of the plan therefore should be capitalized. It is of no consequence that the plan was adopted for the purpose of defending the corporation from a potential hostile takeover attempt. The remaining expenditures are deductible if shown to be specifically allocable to general advisory and defensive tasks.

FACTS

Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

In response to rumors of a possible takeover attempt, during [redacted] paid [redacted] for financial advice and other assistance to defend against any such attempt. [redacted] agreed to assist [redacted] in evaluating and implementing a shareholder rights plan and in implementing "employee-based financing transactions" such as an employee benefits stock plan. In addition, [redacted] was hired to assist [redacted]'s Board, upon its request, with the following:

(1) Assisting [redacted] with the evaluation and implementation of a shareholder rights plan;
(2) Updating the Board's familiarity with the business, operations, properties, financial condition and prospects of [redacted];
(3) Reviewing with management the development of financial projections for [redacted] future performance including sensitivity analysis for such projections;
(4) Providing a framework for a financial valuation of [redacted] and its future prospects;
(5) Advising [redacted] with respect to publicly available information relating to entities which could be potential acquirers of [redacted];
(6) Analyzing [redacted]'s defense posture and making recommendations regarding specific tactical defense alternatives;
(7) Assisting in evaluating strategic defense alternatives including, without limitation, a financial analysis of stock repurchases, stock acquisitions and other related alternatives;
(8) Assisting in analyzing, structuring and effecting a grantor stock ownership program (GSOP transaction) or any such similar employee benefits stock plan which utilizes the [redacted]'s capital stock, including the provision of appropriate opinions of legal counsel;
(9) Providing an ongoing review of [redacted]s stock market activity;
(10) Keeping [redacted] informed about current trends in the merger and acquisition arena;
(11) Providing advice and assistance in the event that an unsolicited offer is threatened or initiated;

(12) If requested, being prepared to review any of the above with [redacted]'s Board of Directors;
(13) Providing such other services as [redacted] and [redacted] may mutually agree upon.

The agreement states that [redacted] would pay $[redacted] to [redacted] within [redacted] days of the implementation of a shareholder rights plan and a GSOP transaction. [redacted] also paid $[redacted] to [redacted] for costs.

On its [redacted] Federal Income Tax Return, [redacted] capitalized $[redacted] of the fees paid to [redacted] It deducted $[redacted] ($[redacted] for costs, $[redacted] for services provided). To determine whether to capitalize or deduct the fees paid, [redacted] assumed that 12 services were provided (presumably 1 through 12 as described above). It allocated one-twelfth of the total fees to each of the 12 services. Six were treated as deductible. Six were capitalized. During the examination, however, [redacted] filed a claim to deduct the full amount paid to [redacted] ($[redacted]).

Also in [redacted], [redacted] paid $[redacted] to [redacted], a law firm. This amount was paid for services in connection with creating and implementing the shareholder rights plan. On its [redacted] return, [redacted] capitalized the full amount of these fees. During the examination, [redacted] filed a claim to deduct them.

The taxpayer's SEC registration statement, Form 8-A, states that the shareholder rights plan was adopted [redacted] To implement the plan, on [redacted] [redacted]'s [redacted] [redacted]s [redacted] [redacted]

[redacted] are only exercisable if one of three triggering events occurs. In essence, the triggering events are:

(1) Someone becomes a 15% owner or someone initiates a tender offer through which they would become the owner of 15% or more of [redacted]'s outstanding common stock. [redacted]

(2) Someone becomes the owner of 15% or more of [redacted]s outstanding common shares (except where an offer is for all outstanding shares of common stock and is determined by the Board to be fair and in the best interests of the

company (a permitted offer transaction)) and [redacted]'s right of redemption has expired. [redacted]

(3) [redacted] is merged or consolidated with another company or more than 50% of its assets or earning power is sold. In this instance, [redacted]

[redacted] or earlier if exchanged or redeemed by [redacted] or upon consummation of a permitted offer transaction followed by a merger.

DISCUSSION

The taxpayer asserts that all the fees paid to [redacted] and to [redacted] are deductible pursuant to I.R.C. § 162 as ordinary and necessary business expenses. [redacted] reasons that since the purpose of these expenditures was to defend the corporation and to maintain the status quo, they are deductible. According to [redacted] the services provided were business planning and advice and did not result in any change in corporate structure or other long-term benefit.

I.R.C. § 162 allows the deduction of all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." An expense is ordinary even if it rarely occurs or only occurs once within the lifetime of the taxpayer. Welch v. Helvering, 290 U.S. 111,114 (1933). An expense is necessary if it is appropriate or helpful for the development of the taxpayer's business. Id. at 113. Deductions, however, are strictly construed and allowed only when there is a clear provision for them. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). In general, expenses incurred to defend a business and its policies from attack are ordinary and necessary and deductible business expenses. American Stores Co. v. Commissioner, 114 T.C. No. 27, 18 (2000); A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482, 487 (7th Cir. 1997).

In contrast, capital expenditures are not currently deductible. INDOPCO, 503 U.S. at 83. Generally, expenditures are capitalized when they create a separate and distinct asset or when the expenditures provides the taxpayer with a benefit that extends beyond the year in which the expenditure occurred. Id. at 82-83. The "mere presence of an incidental future benefit – 'some future aspect' – may not warrant capitalization," however. Id. at 87.

[redacted] felt it was vulnerable to a potential hostile takeover. Pursuant to its duty to protect shareholders, [redacted]'s Board of Directors acted to protect the corporation. Defensive measures are appropriate to avoid changes in company policy, prevent a takeover by a looter and to oppose tender offers which are not in the best interest of the shareholders or whose price is inadequate. The measures taken, however, must be reasonable to the perceived threat. Matthew Bender & Company, Inc. Corporate Acquisitions and Mergers, part 3, chapter 5, (2000).

[redacted]'s Board of Directors hired [redacted] to evaluate the corporation's vulnerability to a takeover and to assist in implementing various measures to reduce unwanted takeover attempts. The enumerated tasks to be performed by [redacted] included reviewing [redacted]'s business, operations, properties, financial condition and prospects, obtaining information about potential acquirers and making recommendations regarding specific defense alternatives. To the extent the taxpayer can establish that the expenditures were paid for such general advisory and defensive tasks, they are deductible. See e.g. Pope & Talbot, T.C. Memo. 1997-116.

[redacted] was also hired to assist [redacted] in implementing two programs, an Employee Stock Option Plan (ESOP)[1] and a Shareholder Rights Plan. Changes in a corporation's capital structure and distribution of stock, such as through a shareholder rights plan, can be effective in preventing a successful tender offer. A typical shareholder rights plan or "poison pill" entitles shareholders to purchase additional shares of the corporation at a fraction of the market price but only upon a change in control in the corporation. Once the rights are exercised, the existing stock interest of the corporation is diluted thereby increasing the number of shares the offering company must obtain to gain control. [redacted]'s plan is a typical poison pill.

Whether a transaction is capital or noncapital depends upon the "origin and nature" of the transaction rather than its "primary purpose."[2] Woodward v. Commissioner, 397 U.S. 572, 577 (1970). [redacted] incorrectly argues that the purpose for its distribution of the right to purchase stock, to defend [redacted] rather than the "origin and nature" of the transaction, determines the tax treatment.

The case of Frederick Weisman Co. v. Commissioner, 97 T.C. 563 (1991) presents a situation somewhat similar to [redacted]'s. In order to enable a corporation to survive, it partially redeemed its stock. A redemption consists of the transfer of the stock ownership back to the corporation in exchange for something of value. Id. at 572. Although the purchase of stock is a capital transaction, the corporation deducted the price paid for the stock and the legal expenses incurred in connection with the redemption. The corporation argued this was a deductible expenditure because it was required in order to protect the corporation. The Tax Court disagreed that the expenses were deductible. Expressly rejecting the "primary purpose" test and relying instead on the "origin and nature" of the transaction, it held that the reason for the redemption – to save the corporation – did not transform the transaction into a deductible expenditure. Id. at

---

[1] Since your question did not address the ESOP and did not provide any specific information regarding the ESOP, this memo does not address it. Generally, an ESOP is compensation to employees. As such, expenses associated with an ESOP would be deductible as ordinary and necessary business expenses pursuant to I.R.C. § 162 regardless of whether or not it was implemented as a defensive measure.

[2] For further discussion of the "origin and nature" test, please see my last [redacted] memo to you dated May 11, 2000.

572-73. Further, the Tax Court held that I.R.C. § 311(a)[3] applied to this transaction thereby further preventing the corporation from recognizing a gain or loss. Id. at 574.

Like the redemption in Weisman,[4] [redacted]s shareholder rights plan is subject to I.R.C. § 311(a) because the plan involved the distribution to shareholders of contingent rights to purchase additional [redacted] stock. This distribution was to shareholders in their capacity as shareholders, not as debtors, creditors or employees. Id. at 567-68. For this reason, as in Weisman, [redacted] cannot deduct the amounts paid in connection with implementation of the plan. In addition, [redacted]'s shareholder rights plan caused a change in the ownership of [redacted]. This also makes it a capital transaction. "Stock is most naturally viewed as a capital asset." Stark v. Commissioner, T.C. Memo. 1999-1 quoting Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 222-23 (1988). Finally, the shareholder rights plan provides a significant benefit beyond the current year. [redacted]

[redacted]s expenditures for business advice, planning and legal counsel incurred in connection with the creation and implementation of the plan are also not deductible. See American Stores Co., 114 T.C. at 19. Professional fees incurred in the process of changing the corporate structure for the benefit of future operations are capitalized. INDOPCO, 503 U.S. at 89.

[redacted]s purpose in implementing the plan – to defend the corporation against hostile takeover attempts – is of no consequence. [redacted] argues that A.E. Staley, 119 F.3d 482 (7th Cir. 1997) and United States v. Federated Dept. Stores, Inc., 171 Bankr. 603 (S.D. Ohio 1994) support its position that expenditures incurred to avoid a hostile takeover attempt are deductible. Those cases, however, did not address the creation of a "poison pill" or the distribution of rights to acquire stock.[5] Secondly, in those cases a hostile takeover actually took place, thereby

---

[3] I.R.C. § 311(a) states "...no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of –

(1) its stock (or rights to acquire its stock), or

(2) property.

[4] The Tax Court in Weisman recognized that I.R.C. § 311(a) applies not only to "gain or loss" but also to the issue of deductibility of costs. Id. at 568, 574.

[5] In A.E. Staley, the taxpayer strengthened the terms of its stockholder rights plan by reducing the amount of the ownership that would trigger the "flip in" provision from 40 percent to 20 percent. A presentation discussing this change was made by the corporation's investment banker in March 1987. The change was made on December 14,1987. A.E. Staley, 105 T.C. 166, 171-72 (1995). The return at issue in the case, however, only included the period from [redacted] to [redacted]. Id. at 167. Neither the Tax Court opinion nor the Seventh Circuit Court of Appeals opinion discussed the shareholder rights plan. Instead, their opinions addressed the expenses associated with the tender offer which commenced [redacted]

supporting the conclusion that the expenditures were deductible because no benefit accrued beyond the year in which the defensive expenditures were made. In A.E. Staley, the Court of Appeals also held, however, that the costs incurred in evaluating and investigating a completed capital transaction such as a merger or "other change in corporate structure" must be capitalized despite the hostile takeover. A.E. Staley, 119 F.3d at 491.

If you have any questions, please contact Yvonne M. Peters at (619) 557-6014.

VALERIE K. LIU
Associate District Counsel

By: YVONNE M. PETERS
Attorney