INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 19, 2005

Third Party Communication: None
Date of Communication: Not Applicable

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Director, Field Operations

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
Corp A =
Parent =
Month 1 =
Month 2 =
Year 1 =
Date a =
Date b =
Date c =
Date d =
Date e =
Date f =
Date g =
Date h =
Date j =
x =
$a =
$b =

$c	=
$d	=
$e	=
$f	=
$g	=
x%	=
y%	=
z%	=
Firm A	=
Firm B	=
Firm C	=
Firm D	=
Firm E	=
Firm F	=
Firm G	=
Firm H	=
J	=
K	=
City A	=

ISSUE:

Whether Taxpayer may deduct as an ordinary and necessary business expense under § 162(a) of the Internal Revenue Code certain costs incurred in connection with an initial public offering of stock.

CONCLUSION:

Taxpayer may not deduct any of the costs incurred in connection with the initial public offering of stock.

FACTS:

Taxpayer is the consolidated group of corporations that emerged from the transaction described below. Prior to Year 1, Corp A was the parent corporation of a consolidated group.

. Corp A's stock was not listed on a national securities exchange or traded in the organized over-the-counter markets,

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In Month 1, in connection with an initial public offering ("the IPO"),

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. The net proceeds from the IPO were $b.

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Taxpayer paid financial advisory, legal, accounting, and other fees totaling $c in connection with the IPO. The financial advisor (investment banker) selling commissions and underwriting discounts were withheld by the investment bankers from the IPO proceeds. No other payments were made to the investment bankers. The underwriting discounts and selling commissions totaled $d, of which $e was paid to Firm A and $f was paid to Firm B. Taxpayer treated the legal, accounting, and other fees as a reduction of the capital proceeds from the IPO for tax purposes and did not deduct them on its Year 1 consolidated income tax return.

During an examination of Taxpayer's Year 1 consolidated income tax return by the Internal Revenue Service, Taxpayer filed an informal claim for refund requesting that $g of the costs previously not deducted with respect to the IPO be deducted on its Year 1 return as "pre-decisional & investigatory" costs and "other deductible" costs. The $g represents x% of the total $c costs of the IPO. The $g costs that Taxpayer requested to deduct include financial advisory fees, legal fees, and "filing, proxy & other fees."

In response to an information document request ("IDR") from the Service, Taxpayer provided a letter from Firm A dated Date h, stating that Firm A "does not allocate transaction fees it receives among various services provided by it in connection with a transaction. [Firm A] also does not keep records detailing the various specific services that were rendered under this and other engagements or time spent by [Firm A] professionals in performing such services."

Also in response to an IDR, Taxpayer stated the following regarding the letter from Firm A:

> The stated purpose of the letter was "to provide an overall understanding" of the services rendered and to provide "reasonable estimates of the percentage of time [Firm A] spent on specific services in the course of [Firm A]'s engagement based upon the recollection of the various professionals who worked on the engagement." It went on to estimate that [y%] of its time was "attributable to conducting due diligence, assisting [Taxpayer] in evaluating the suitability of the IPO and in making its decision whether or not to proceed with the IPO" and that "these services were investigatory in nature and rendered on or before Date f, the date on which the [Taxpayer] Board of Directors approved the IPO."

Firm B provided a similar letter, dated Date j, estimating that z% of its time was "attributable to conducting due diligence, assisting [Taxpayer] in evaluating the suitability of the IPO and in making its decision whether or not to proceed with the IPO" and stating that "these services were investigatory in nature and rendered on or before Date f."

Taxpayer stated in a response to an IDR that there were no engagement letters for the investment bankers. The underwriting agreement between Taxpayer and the investment bankers for selling the stock in the IPO provides for fees in the form of underwriting discounts and associated expenses to be paid by Taxpayer to the underwriters.

Taxpayer also stated the following in an IDR response:

> In the past, [Taxpayer]
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> and the increased public disclosure requirements. In early [Year 1], however, [Taxpayer] decided
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> industry, such as
> Additionally, the
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> . As is typical of an investment banking relationship, [Firm A] continually offered analysis and financial advice with the understanding that [Firm A] would be compensated for all its prior investigatory services when a transaction was selected.

> Following the [Month 2] meeting and on or before Date f, the date the [Taxpayer] Board of Directors approved the IPO, the "pre-decisional" investigatory services that [Firm A] rendered to [Taxpayer] in connection with [Taxpayer's] IPO included 1) reviewing and analyzing the products, labor, reputation, etc. of [Taxpayer]; 2) reviewing and understanding the businesses, operations, properties, and financial condition of [Taxpayer]; 3) meeting with [Taxpayer]'s independent auditors, [Firm C]; 4) assisting with and making a presentation to the [Taxpayer] Board of Directors on Date e that reviewed for the board members the mechanics of an IPO, and the potential benefits and burden from becoming a public company; 5) conducting financial analysis of [Taxpayer] in the context of a possible IPO; 6) preparation for and attendance at meetings with [Taxpayer] management held on Date a, Date c, and Date d to discuss the benefits and challenges of becoming a public company, the general mechanics of an IPO and the equity market conditions at the time; and 7) providing advice to [Taxpayer] to assist [Taxpayer] in ascertaining whether the IPO would be a good business fit for [Taxpayer] and whether it would enhance the reputation and market recognition of [Taxpayer].
>
> At the Date d management meeting, in addition to updating the IPO information from the earlier presentations, [Firm A] provided a strategic overview of [Taxpayer], identified various objectives of [Taxpayer], and the strategies to achieve those objectives. Several strategic alternatives to an IPO were also identified by [Firm A], including: (i) an alliance with ; (ii) acquisitions of companies; (iii) a merger or other alliance with . At the end of the Date d meeting, [Firm A] advised [Taxpayer] to pursue an IPO only if the company could determine whether the strategic benefits outweighed the , scrutiny by outsiders, and changes in corporate governance. On Date f, the [Taxpayer] board made a final decision to undertake an IPO.

Taxpayer provided presentations from meetings on Date a, Date c, Date d, and Date e. These presentations only laid out the benefits of an IPO. They contained no information on alternatives to an IPO. Taxpayer has provided no other documentation supporting the information quoted above. Taxpayer has provided no documentation for any meetings with Firm B.

Taxpayer provided documentation for the legal costs in the form of legal billings for the IPO project. Firm D prepared the SEC filings, *i.e.*, the proxy statement, the prospectus, and the S-4 (Registration Statement under the Securities Act of 1933). A Date g invoice from Firm D indicates that preparation of the S-4 began on Date b. Taxpayer characterizes some of the legal costs (those associated with the S-4) as "non-predecisional." Legal costs that Taxpayer considers to be pre-decisional, and thus deductible, include payments made to Firm E and Firm F. Taxpayer stated that Firm D and Firm E "rendered legal advisory services to assist [Taxpayer] in making its decision whether to engage in the IPO." These services "included conferring with [Taxpayer's] other advisors regarding strategic issues relating to doing an IPO, due diligence legal research, research regarding [Taxpayer's] charter, attention and advice regarding legal matters relating to a possible IPO, and attendance and participation in several meetings and conference calls with [Taxpayer] and its other advisors."

"Filing, proxy & other fees" claimed by Taxpayer to be pre-decisional include payments made to Firm G, which "provided public relations services to assist [Taxpayer] in making its decision whether to engage in the IPO." Taxpayer also made a payment to Firm H for rendering communications training for a member of [Taxpayer] management.

LAW AND ANALYSIS:

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

It is well established that a corporation may not deduct or amortize costs incurred in connection with issuing its capital stock. *See, e.g.*, *McCrory Corp. v. United States*, 651 F.2d 828 (2d Cir. 1981) (costs incident to the issuance of stock or in raising capital are nondeductible capital outlays); *Davis v. Commissioner*, 151 F.2d 441 (8th Cir. 1945) (SEC registration costs and underwriting commissions were an offset against sale price and not deductible as a business expense); *Baltimore & O.R. Co. v. Commissioner*, 78 F.2d 460 (4th Cir. 1935) (expenditures for underwriting commissions and printing, etc. in connection with sale of stock issue not deductible as an expense or a loss); *Surety Finance Co. of Tacoma v. Commissioner*, 77 F.2d 221 (9th Cir. 1935) (no deduction or amortization allowed for corporation's costs incurred in selling its capital stock); *Affiliated Capital Corp. v. Commissioner*, 88 T.C. 1157 (1987) (costs of preparing and filing post-effective amendments to SEC registration were non-deductible costs of raising capital and issuing capital stock); *United Carbon Co. v. Commissioner*, 32 B.T.A. 1000 (1935) (expenses for numbering stock certificates and transfer services in connection with original issuance of taxpayer's stock not deductible); *Commercial Investment Trust Corp. v. Commissioner*, 28 B.T.A. 143 (1933) (various expenses incurred in connection with issuance of preferred stock that was to be retired at three percent per year not deductible or amortizable over stock's expected life), *aff'd per curiam*, 74 F.2d 1015 (2d Cir. 1935); *Corning Glass Works v. Lucas*, 37 F.2d 798 (expenses incident to sale of capital stock not deductible ordinary and necessary business expenses); Rev. Rul. 79-2, 1979-1 C.B. 98 (expenses incurred in preparation for public offering of stock are considered costs incurred to sell the stock and cannot be deducted).

Instead, stock issuance costs are treated as a reduction in the proceeds of the stock sale. They are considered the equivalent of selling the stock at a discount; thus, they do not create an expense that could give rise to a deduction. *See Barbour Coal Co. v. Commissioner*, 74 F.2d 163, 164 (10th Cir. 1934) ("It [a commission paid for selling stock] merely reduces the net returns from the sale of the stock and reduces the available capital. It has no relation to operating expenses. It is equivalent for income tax purposes to the sale of stock at a discount."); *Simmons Co. v. Commissioner*, 33 F.2d 75, 76 (1st Cir. 1929) ("Commissions paid for marketing stock simply diminish the net return from the stock issue. Financially, they are equivalent to an issue of stock at a discount from par; the par value must be carried as a liability without an off-setting, equal, amount of cash or property."); *Affiliated Capital Corp.*, 88 T.C. at 1166.

Because stock issuance costs do not create an asset that is exhausted over time or lost when a corporation dissolves, is liquidated, or merges with another corporation, they are not deductible on those occasions either. *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872 (2d Cir. 1936) (previously-capitalized stock listing fee not deductible as loss when taxpayer merged with another corporation); *Pacific Coast Biscuit Co. v. Commissioner*, 32 B.T.A. 39 (1935) (previously-capitalized expenses for retirement of old stock and issuance of new stock not deductible upon corporation's dissolution); *Van Keuren v. Commissioner*, 28 B.T.A. 480 (1933) (costs for commissions, salaries, advertising, rent, etc. in connection with sale of corporation's stock not deductible as loss when corporation is dissolved). Essentially, expenditures incurred in connection with raising capital by issuing stock are not deductible at any time. *McCrory*, 651 F.2d at 835 & n.10. Costs incurred in preparing for a stock offering may only be deducted if the plan to issue the stock is abandoned. *See* Rev. Rul. 79-2.

Although Taxpayer has not provided any written legal arguments for its position that the $g in transaction costs are deductible, its informal claim for refund appears to be based on the characterization of these costs as "pre-decisional investigatory" costs, which Taxpayer contends are deductible under authorities such as Rev. Rul. 99-23, 1999-1 C.B. 998, and *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).

Rev. Rul. 99-23 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 effectively 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 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.

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 holding of Rev. Rul. 99-23 evolves from the capitalization line drawn in Rev. Rul. 77-254, 1977-2 C.B. 63. Rev. Rul 77-254 considers which costs incurred in the potential acquisition of a new business are capital acquisition costs for purposes of §§ 165 and 263. In the ruling, the taxpayer placed advertisements in several newspapers, traveled to various locations to investigate businesses that were for sale, and commissioned audits to evaluate the potential of several of these businesses. Eventually, the taxpayer decided to purchase a specific business and retained a law firm to draft the necessary purchase documents. The taxpayer ultimately abandoned all attempts to acquire the business and reported a loss under § 165(c)(2). In the ruling, the Service states that:

> Expenses incurred in the course of a general search for or preliminary investigation of a business or investment include those expenses related to the decisions *whether* to enter a transaction and *which* transaction to enter. . . . Once the taxpayer has focused on the acquisition of a specific business or investment, expenses that are related to an attempt to acquire such business or investment are capital in nature.

Id. Rev. Rul 77-254 concludes that the expenses for advertisements, travel to search for a new business, and the cost of audits designed to help the taxpayer decide whether to attempt an acquisition were investigatory expenses that were not deductible under § 165(c)(2) because the taxpayer was not already carrying on the relevant trade or business. The legal and other expenses incurred in the attempt to complete the purchase of a specific business were capital in nature, and thus were deductible upon the abandonment under § 165(c)(2).

The Eighth Circuit has applied the analysis used in Rev. Rul. 99-23 in the context of expenditures incurred in determining whether to expand a business through a merger. *Wells Fargo* involved the deductibility of a target corporation's investigatory costs incurred in connection with a corporate consolidation. 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. *Id.* at 889. The Eighth Circuit agreed that any investigatory expenses that post-dated the "final decision" to consolidate should be capitalized. *Id.*

Although *Wells Fargo* and Rev. Rul. 99-23 permitted a deduction for investigatory costs incurred in connection with the transaction at issue in each case, their holdings do not extend to permit a deduction for investigatory costs related to every type of capital transaction. For example, those authorities do not apply to the costs of investigating the acquisition of a specific capital asset. *See Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982). The taxpayer in *Ellis Banking* was a bank holding company that expanded into new markets by acquiring the stock of other banks. In preparation for the proposed acquisition of the stock of a particular bank (Parkway), the taxpayer inspected Parkway's books and records to evaluate its financial condition. Because the acquisition agreement was contingent upon several terms and conditions, the taxpayer was not obligated to complete the acquisition if the results of this inspection did not meet certain criteria. The taxpayer argued that costs incurred in this investigation were currently deductible under § 162 because they were not made in connection with the acquisition but in connection with the decision to acquire the stock and with the evaluation of the local market. In rejecting this argument, the court stated:

> We agree with [the taxpayer] that the expenditures were made in the investigation of Parkway and without a firm commitment to buy. Nevertheless, they are not deductible. . . . [T]he expenses of investigating a capital investment are properly allocable to that investment and must therefore be capitalized. That the decision to make the investment is not final at the time of the expenditure does not change the character of the investment.

Id. at 1382.

The Service has also considered the deductibility of investigatory expenditures incurred to acquire specific capital assets. In Rev. Rul. 74-104, 1974-1 C.B. 70, the Service analyzed the deductibility of "evaluation" expenditures incurred by a corporation in the business of acquiring existing residential property to renovate and sell to the general public. Prior to acquiring property for renovation, the taxpayer incurred expenditures in evaluating a potential locality to determine the feasibility of selling such property in the locality. The evaluation expenditures included the cost of securing an initial report from an independent agent, and salaries, travel, and other related costs in evaluating the agent's report and the locality involved. The ruling holds that because the expenditures were incurred by the taxpayer in connection with acquiring existing residential property and provided benefits beyond the current taxable year through the sale of the renovated property, such expenditures were capital expenditures under § 263 that must be taken into account as part of the cost of acquiring the property.

The "whether and which" analysis used in Rev. Rul 99-23 and Rev. Rul. 77-254 is even less appropriate for determining the deductibility of stock issuance costs than it is for determining the deductibility of costs incurred in acquiring a specific asset. Stock issuance costs are not capitalized to any specific tangible or intangible asset. Instead, they simply reduce the proceeds received by the corporation on the sale of the stock, as if the stock had been sold at a discount. *Affiliated Capital Corp.*, 88 T.C. at 1166; *Barbour Coal*, 74 F.2d at 164; *Simmons*, 33 F.2d at 76. This is why no deduction is allowed for stock issuance costs when a corporation's existence is terminated through dissolution, merger, etc. *See, e.g.*, *Pacific Coast Biscuit*, 32 B.T.A at 42 ("[M]oney paid out to acquire capital does not result in the acquisition of any asset other than the capital itself."). By contrast, the "whether and which" analysis for business expansion and acquisition costs seeks to differentiate expenses that are deductible (or amortizable under § 195) from expenditures that must be capitalized to tangible or intangible assets acquired in the transaction. Thus, there is no reason to distinguish "pre-decisional investigatory" costs related to stock issuance from other stock issuance costs. Under the precedents cited above, all costs that are sufficiently connected to a corporation's issuance of its stock are non-deductible offsets against the proceeds received from the stock sale.

Further evidence that the "whether and which" investigatory cost analysis is inapplicable to stock issuance costs can be found in § 1.263(a)-5 of the Income Tax Regulations. Section 1.263(a)-5(a) provides that a taxpayer must capitalize an amount paid to facilitate certain transactions, including a stock issuance, § 1.263(a)-5(a)(8). In Example 15 of § 1.263(a)-5(l), Y corporation's board of directors authorizes an initial public offering of Y's stock to fund future growth. Y pays $5,000,000 in professional fees for investment banking services related to the determination of the offering price and legal services related to the development of the offering prospectus and the registration and issuance of the stock. The investment banking and legal services are performed both before and after board authorization. The example concludes that the entire $5,000,000 is an amount paid to facilitate a stock issuance under § 1.263(a)-5(a)(8), and is therefore non-deductible. Because § 1.263(a)-5 is effective for costs paid or incurred on or after December 31, 2003, it does not directly apply to the costs at issue. However, it illustrates that Rev. Rul. 99-23 does not change the long-standing rule that stock issuance costs are not deductible, regardless of whether they are incurred before or after the date the taxpayer makes a final decision to enter into the stock issuance transaction.

Accordingly, Taxpayer may not deduct any of the costs it incurred in connection with the IPO, regardless of whether some of those costs may be characterized as "pre-decisional investigatory" costs. Taxpayer incurred transaction costs in the form of financial advisory (investment banker), legal, and other fees for the purpose of issuing stock via the IPO. The investment banker fees paid to Firm A and Firm B were in the form of underwriting discounts and selling commissions. There were no engagement letters or invoices. There is no evidence of any payments for services to these firms other than the withheld proceeds for the underwriting of the IPO. Because the expenditures at issue simply reduced the amount of capital Taxpayer received for the sale of the stock, Taxpayer incurred no deductible expenses under § 162(a).

Taxpayer has claimed most of the legal costs incurred prior to Date f, the date of approval of the IPO by the board of directors, to be "pre-decisional." The invoice from Firm D dated Date g shows that work began on Form S-4 on Date b, suggesting that management had made the decision to go forward with the IPO by Date b.

Nonetheless, even assuming that Date f is the correct "final decision" date, we have concluded that expenses incurred in connection with the IPO both before and after that date are non-deductible reductions to capital inflow.

Taxpayer has not provided any evidence that any portion of the $g in costs it claims to be deductible was not related to the IPO. Further, there is no evidence that the planned IPO was abandoned, as in Rev. Rul. 79-2. Therefore, there is no basis for allowing a deduction for any portion of the $g claimed.

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.