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Reg. Section 1.263(a)-5(g)(2)(i)

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

(a)General rule. A taxpayer must capitalize an amount paid to facilitate (within the meaning of paragraph (b) of this section) each of the following transactions, without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction:

(1) An acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition).

(2) 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) or 707(b) (see §1.263(a)-4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, or to facilitate the acquisition of an ownership interest in a business entity, where the taxpayer and the business entity are not related within the meaning of section 267(b) or 707(b) immediately after the acquisition).

(3) An acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise).

(4) A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in section 368 and distributions of stock by the taxpayer as described in section 355).

(5) A transfer described in section 351 or section 721 (whether the taxpayer is the transferor or transferee).

(6) A formation or organization of a disregarded entity.

(7) An acquisition of capital.

(8) A stock issuance.

(9) A borrowing.

For purposes of this section, a borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization. A borrowing also includes debt issued in a debt for debt exchange under §1.1001-3.

(10) Writing an option.

(b) Scope of facilitate.

(1) In general. Except as otherwise provided in this section, an amount is paid to facilitate a transaction described in paragraph (a) of this section 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. An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange. For example, the purchase price paid to the target of an asset acquisition in exchange for its assets is not an amount paid to facilitate the acquisition. Similarly, the purchase price paid by an acquirer to the target's shareholders in exchange for their stock in a stock acquisition is not an amount paid to facilitate the acquisition of the stock. See §1.263(a)-1, §1.263(a)-2, and §1.263(a)-4 for rules requiring capitalization of the purchase price paid to acquire property.

(2) Ordering rules. An amount paid in the process of investigating or otherwise pursuing both a transaction described in paragraph (a) of this section and an acquisition or creation of an intangible described in §1.263(a)-4 is subject to the rules contained in this section, and not to the rules contained in §1.263(a)-4. In addition, an amount required to be capitalized by §1.263(a)-1, §1.263(a)-2, or §1.263(a)-4 does not facilitate a transaction described in paragraph (a) of this section.

(c) Special rules for certain costs.

(1) Borrowing costs. An amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing) described in paragraph (a) of this section.

(2) Costs of asset sales. An amount paid by a taxpayer to facilitate a sale of its assets does not facilitate another transaction (other than the sale) described in paragraph (a) of this section. For example, where a target corporation, in preparation for a merger with an acquiring corporation, sells assets that are not desired by the acquiring corporation, amounts paid to facilitate the sale of the unwanted assets are not required to be capitalized as amounts paid to facilitate the merger.

(3) Mandatory stock distributions. An amount paid in the process of investigating or otherwise pursuing a distribution of stock by a taxpayer to its shareholders does not facilitate a transaction described in paragraph (a) of this section if the divestiture of the stock (or of properties transferred to an entity whose stock is distributed) is required by law, regulatory mandate, or court order. A taxpayer is not required to capitalize (under this section or §1.263(a)-4) an amount paid to organize (or facilitate the organization of) an entity if the entity is organized solely to receive properties that the taxpayer is required to divest by law, regulatory mandate, or court order and if the taxpayer distributes the stock of the entity to its shareholders. A taxpayer also is not required to capitalize (under this section or §1.263(a)-4) an amount paid to transfer property to an entity if the taxpayer is required to divest itself of that property by law, regulatory mandate, or court order and if the stock of the recipient entity is distributed to the taxpayer's shareholders.

(4)Bankruptcy reorganization costs. An amount paid to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code by a taxpayer that is the debtor under the proceeding constitutes an amount paid to facilitate a reorganization within the meaning of paragraph (a)(4) of this section, regardless of the purpose for which the proceeding is instituted. For example, an amount paid to prepare and file a petition under Chapter 11, to obtain an extension of the exclusivity period under Chapter 11, to formulate plans of reorganization under Chapter 11, to analyze plans of reorganization formulated by another party in interest, or to contest or obtain approval of a plan of reorganization under Chapter 11 facilitates a reorganization within the meaning of this section. However, amounts specifically paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization under Chapter 11 that resolves tort liabilities of the taxpayer do not facilitate a reorganization within the meaning of paragraph (a)(4) of this section if the amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. In addition, an amount paid by the taxpayer to defend against the commencement of an involuntary bankruptcy proceeding against the taxpayer does not facilitate a reorganization within the meaning of paragraph (a)(4) of this section. An amount paid by the debtor to operate its business during a Chapter 11 bankruptcy proceeding is not an amount paid to institute or administer the bankruptcy proceeding and does not facilitate a reorganization. Such amount is treated in the same manner as it would have been treated had the bankruptcy proceeding not been instituted.

(5)Stock issuance costs of open-end regulated investment companies. Amounts paid by an open-end regulated investment company (within the meaning of section 851) to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section unless the amounts are paid during the initial stock offering period.

(6)Integration costs. An amount paid to integrate the business operations of the taxpayer with the business operations of another does not facilitate a transaction described in paragraph (a) of this section, regardless of when the integration activities occur.

(7)Registrar and transfer agent fees for the maintenance of capital stock records. An amount paid by a taxpayer to a registrar or transfer agent in connection with the transfer of the taxpayer's capital stock does not facilitate a transaction described in paragraph (a) of this section unless the amount is paid with respect to a specific transaction described in paragraph (a). For example, a taxpayer is not required to capitalize periodic payments to a transfer agent for maintaining records of the names and addresses of shareholders who trade the taxpayer's shares on a national exchange. By comparison, a taxpayer is required to capitalize an amount paid to the transfer agent for distributing proxy statements requesting shareholder approval of a transaction described in paragraph (a) of this section.

(8)Termination payments and amounts paid to facilitate mutually exclusive transactions. An amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction described in paragraph (a) of this section constitutes an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive. An amount paid to facilitate a transaction described

in paragraph (a) of this section is treated as an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive.

(d)Simplifying conventions.

(1)In general. For purposes of this section, employee compensation (within the meaning of paragraph (d)(2) of this section), overhead, and de minimis costs (within the meaning of paragraph (d)(3) of this section) are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section.

(2)Employee compensation.

(i) In general. The term employee compensation means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(ii) Certain amounts treated as employee compensation. For purposes of this section, a guaranteed payment to a partner in a partnership is treated as employee compensation. For purposes of this section, annual compensation paid to a director of a corporation is treated as employee compensation. For example, an amount paid to a director of a corporation for attendance at a regular meeting of the board of directors (or committee thereof) is treated as employee compensation for purposes of this section. However, an amount paid to the director for attendance at a special meeting of the board of directors (or committee thereof) is not treated as employee compensation. An amount paid to a person that is not an employee of the taxpayer (including the employer of the individual who performs the services) is treated as employee compensation for purposes of this section only if the amount is paid for secretarial, clerical, or similar administrative support services (other than services involving the preparation and distribution of proxy solicitations and other documents seeking shareholder approval of a transaction described in paragraph (a) of this section). In the case of an affiliated group of corporations filing a consolidated federal income tax return, a payment by one member of the group to a second member of the group for services performed by an employee of the second member is treated as employee compensation if the services provided by the employee are provided at a time during which both members are affiliated.

(3)De minimis costs.

(i) In general. The term de minimis costs means amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a) of this section if, in the aggregate, the amounts do not exceed \$5,000 (or such greater amount as may be set forth in published guidance). If the amounts exceed \$5,000 (or such greater amount as may be set forth in published guidance), none of the amounts are de minimis costs within the meaning of this paragraph (d)(3). For purposes of this paragraph (d)(3), an amount paid in the form of property is valued at its fair market value at the time of the payment.

(ii) Treatment of commissions. The term de minimis costs does not include commissions paid to facilitate a transaction described in paragraph (a) of this section.

(4) Election to capitalize. A taxpayer may elect to treat employee compensation, overhead, or de minimis costs paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a) of this section as amounts that facilitate the transaction. The election is made separately for each transaction and applies to employee compensation, overhead, or de minimis costs, or to any combination thereof. For example, a taxpayer may elect to treat overhead and de minimis costs, but not employee compensation, as amounts that facilitate the transaction. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the transaction in the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (d)(4) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(e) Certain acquisitive transactions.

(1) In general. Except as provided in paragraph (e)(2) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction (as described in paragraph (e)(3) of this section) facilitates the transaction within the meaning of this section only if the amount relates to activities performed on or after the earlier of-

(i) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or

(ii) The date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) the date determined under this paragraph (e)(1)(ii) is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.

(2) Exception for inherently facilitative amounts. An amount paid in the process of investigating or otherwise pursuing a covered transaction facilitates that transaction if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined under paragraph (e)(1) of this section. An amount is inherently facilitative if the amount is paid for-

- (i) Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;
- (ii) Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (for example, obtaining tax advice on the application of section 368);
- (iii) Preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement);
- (iv) Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;
- (v) Obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or
- (vi) Conveying property between the parties to the transaction (for example, transfer taxes and title registration costs).

(3) Covered transactions. For purposes of this paragraph (e), the term covered transaction means the following transactions:

- (i) A taxable acquisition by the taxpayer of assets that constitute a trade or business.
- (ii) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b).
- (iii) A reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

(f) Documentation of success-based fees. An amount paid that is contingent on the successful closing of a transaction described in paragraph (a) of this section is an amount paid to facilitate the transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. This documentation must be completed on or before the due date of the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the transaction closes. For purposes of this paragraph (f), documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and must consist of supporting records (for example, time records, itemized invoices, or other records) that identify-

- (1) The various activities performed by the service provider;
- (2) The amount of the fee (or percentage of time) that is allocable to each of the various activities performed;

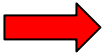
(3) Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and

(4) The name, business address, and business telephone number of the service provider.

(g) Treatment of capitalized costs.

(1) Tax-free acquisitive transactions. [Reserved]

(2) Taxable acquisitive transactions.



(i) Acquirer. In the case of an acquisition, merger, or consolidation that is not described in section 368, an amount required to be capitalized under this section by the acquirer is added to the basis of the acquired assets (in the case of a transaction that is treated as an acquisition of the assets of the target for federal income tax purposes) or the acquired stock (in the case of a transaction that is treated as an acquisition of the stock of the target for federal income tax purposes).

(ii) Target.

(A) Asset acquisition. In the case of an acquisition, merger, or consolidation that is not described in section 368 and that is treated as an acquisition of the assets of the target for federal income tax purposes, an amount required to be capitalized under this section by the target is treated as a reduction of the target's amount realized on the disposition of its assets.

(B) Stock acquisition. [Reserved]

(3) Stock issuance transactions. [Reserved]

(4) Borrowings. For the treatment of amounts required to be capitalized under this section with respect to a borrowing, see §1.446-5.

(5) Treatment of capitalized amounts by option writer. An amount required to be capitalized by an option writer under paragraph (a)(10) of this section is not currently deductible under section 162 or 212. Instead, the amount required to be capitalized generally reduces the total premium received by the option writer. However, other provisions of law may limit the reduction of the premium by the capitalized amount (for example, if the capitalized amount is never deductible by the option writer).

(h) Application to accrual method taxpayers. For purposes of this section, the terms amount paid and payment mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of §1.446-1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(i) [Reserved]

(j)Coordination with other provisions of the Internal Revenue Code. Nothing in this section changes the treatment of an amount that is specifically provided for under any other provision of the Internal Revenue Code (other than section 162(a) or 212) or regulations thereunder.

(k)Treatment of indirect payments. For purposes of this section, references to an amount paid to or by a party include an amount paid on behalf of that party.

(l)Examples. The following examples illustrate the rules of this section:

Example (1). Costs to facilitate. Q corporation pays its outside counsel \$20,000 to assist Q in registering its stock with the Securities and Exchange Commission. Q is not a regulated investment company within the meaning of section 851. Q's payments to its outside counsel are amounts paid to facilitate the issuance of stock. Accordingly, Q must capitalize its \$20,000 payment under paragraph (a)(8) of this section (whether incurred before or after the issuance of the stock and whether or not the registration is productive of equity capital).

Example (2). Costs to facilitate. Q corporation seeks to acquire all of the outstanding stock of Y corporation. To finance the acquisition, Q must issue new debt. Q pays an investment banker \$25,000 to market the debt to the public and pays its outside counsel \$10,000 to prepare the offering documents for the debt. Q's payment of \$35,000 facilitates a borrowing and must be capitalized under paragraph (a)(9) of this section. As provided in paragraph (c)(1) of this section, Q's payment does not facilitate the acquisition of Y, notwithstanding the fact that Q incurred the new debt to finance its acquisition of Y. See §1.446-5 for the treatment of Q's capitalized payment.

Example (3). Costs to facilitate. (i) Z agrees to pay investment banker B \$1,000,000 for B's services in evaluating four alternative transactions (\$250,000 for each alternative): An initial public offering; a borrowing of funds; an acquisition by Z of a competitor; and an acquisition of Z by a competitor. Z eventually decides to pursue a borrowing and abandons the other options. The \$250,000 payment to evaluate the possibility of a borrowing is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(9) of this section. Accordingly Z must capitalize that \$250,000 payment to B. See §1.446-5 for the treatment of Z's capitalized payment.

(iii) The \$250,000 payment to evaluate the possibility of an initial public offering is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(8) of this section. Accordingly, Z must capitalize that \$250,000 payment to B under this section. Because the borrowing and the initial public offering are not mutually exclusive transactions, the \$250,000 is not treated as an amount paid to facilitate the borrowing. When Z abandons the initial public offering, Z may recover under section 165 the \$250,000 paid to facilitate the initial public offering.

(iv) The \$500,000 paid by Z to evaluate the possibilities of an acquisition of Z by a competitor and an acquisition of a competitor by Z are amounts paid in the process of investigating or otherwise pursuing transactions described in paragraphs (a) and (e)(3) of this section. Accordingly, Z is only required to capitalize under this section the portion of the \$500,000 payment that relates to inherently facilitative activities under paragraph (e)(2) of this section or to activities performed on or after the date determined under paragraph (e)(1) of this section. Because the borrowing and the possible acquisitions are not mutually exclusive transactions, no portion of the \$500,000 is treated as an amount paid to facilitate the borrowing. When Z

abandons the acquisition transactions, Z may recover under section 165 any portion of the \$500,000 that was paid to facilitate the acquisitions.

Example (4). Corporate acquisition.

(i) On February 1, 2005, R corporation decides to investigate the acquisition of three potential targets: T corporation, U corporation, and V corporation. R's consideration of T, U, and V represents the consideration of three distinct transactions, any or all of which R might consummate and has the financial ability to consummate. On March 1, 2005, R enters into an exclusivity agreement with T and stops pursuing U and V. On July 1, 2005, R acquires all of the stock of T in a transaction described in section 368. R pays \$1,000,000 to an investment banker and \$50,000 to its outside counsel to conduct due diligence on T, U, and V; determine the value of T, U, and V; negotiate and structure the transaction with T; draft the merger agreement; secure shareholder approval; prepare SEC filings; and obtain the necessary regulatory approvals.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on T, U and V prior to March 1, 2005 (the date of the exclusivity agreement) are not amounts paid to facilitate the acquisition of the stock of T, U or V and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on T on and after March 1, 2005, are amounts paid to facilitate the acquisition of the stock of T and must be capitalized under paragraph (a)(2) of this section.

(iii) Under paragraph (e)(2) of this section, the amounts paid to determine the value of T, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain necessary regulatory approvals are inherently facilitative amounts paid to facilitate the acquisition of the stock of T and must be capitalized, regardless of whether those activities occur prior to, on, or after March 1, 2005.

(iv) Under paragraph (e)(2) of this section, the amounts paid to determine the value of U and V are inherently facilitative amounts paid to facilitate the acquisition of U or V and must be capitalized. Because the acquisition of U, V, and T are not mutually exclusive transactions, the costs that facilitate the acquisition of U and V do not facilitate the acquisition of T. Accordingly, the amounts paid to determine the value of U and V may be recovered under section 165 in the taxable year that R abandons the planned mergers with U and V.

Example (5). Corporate acquisition; employee bonus. Assume the same facts as in Example 4, except R pays a bonus of \$10,000 to one of its corporate officers who negotiated the acquisition of T. As provided by paragraph (d)(1) of this section, Y is not required to capitalize any portion of the bonus paid to the corporate officer.

Example (6). Corporate acquisition; integration costs. Assume the same facts as in Example 4, except that, before and after the acquisition is consummated, R incurs costs to relocate personnel and equipment, provide severance benefits to terminated employees, integrate records and information systems, prepare new financial statements for the combined entity, and reduce redundancies in the combined business operations. Under paragraph (c)(6) of this section, these costs do not facilitate the acquisition of T. Accordingly, R is not required to capitalize any of these costs under this section.

Example (7). Corporate acquisition; compensation to target's employees. Assume the same facts as in Example 4, except that, prior to the acquisition, certain employees of T held unexercised options issued pursuant to T's stock option plan. These options granted the employees the right to purchase T stock at a fixed option price. The options did not have a readily ascertainable value (within the meaning of §1.83-7(b)), and thus no amount was included in the employees' income when the options were granted. As a condition of the acquisition, T is required to terminate its stock option plan. T therefore agrees to pay its employees who hold unexercised stock options the difference between the option price and the current value of T's stock in consideration of their agreement to cancel their unexercised options. Under paragraph (d)(1) of this section, T is not required to capitalize the amounts paid to its employees. See section 83 for the treatment of amounts received in cancellation of stock options.

Example (8). Asset acquisition; employee compensation. N corporation owns tangible and intangible assets that constitute a trade or business. M corporation purchases all the assets of N in a taxable transaction. Under paragraph (a)(1) of this section, M must capitalize amounts paid to facilitate the acquisition of the assets of N. Under paragraph (d)(1) of this section, no portion of the salaries of M's employees who work on the acquisition are treated as facilitating the transaction.

Example (9). Corporate acquisition; retainer. Y corporation's outside counsel charges Y \$60,000 for services rendered in facilitating the friendly acquisition of the stock of Y corporation by X corporation. Y has an agreement with its outside counsel under which Y pays an annual retainer of \$50,000. Y's outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y's outside counsel offsets \$50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of \$10,000. The \$60,000 legal fee is an amount paid to facilitate the acquisition of an ownership interest in Y as described in paragraph (a)(3) of this section. Y must capitalize the full amount of the \$60,000 legal fee.

Example (10). Corporate acquisition; antitrust defense costs. On March 1, 2005, V corporation enters into an agreement with X corporation to acquire all of the outstanding stock of X. On April 1, 2005, federal and state regulators file suit against V to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. V enters into a consent agreement with regulators on May 1, 2005, that allows the acquisition to proceed, but requires V to hold separate the business operations of X pending the outcome of the antitrust suit and subjects V to possible divestiture. V acquires title to all of the outstanding stock of X on June 1, 2005. After June 1, 2005, the regulators pursue antitrust litigation against V seeking rescission of the acquisition. V pays \$50,000 to its outside counsel for services rendered after June 1, 2005, to defend against the antitrust litigation. V ultimately prevails in the antitrust litigation. V's costs to defend the antitrust litigation are costs to facilitate its acquisition of the stock of X under paragraph (a)(2) of this section and must be capitalized. Although title to the shares of X passed to V prior to the date V incurred costs to defend the antitrust litigation, the amounts paid by V are paid in the process of pursuing the acquisition of the stock of X because the acquisition was not complete until the antitrust litigation was ultimately resolved. V must capitalize the \$50,000 in legal fees.

Example (11). Corporate acquisition; defensive measures.

(i) On January 15, 2005, Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a

potential "white knight" acquirer. Y also pays amounts to complete a defensive recapitalization, and pays \$50,000 to an investment banker for a fairness opinion regarding Z's initial offer. Y's efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2005, Y's board of directors decides to abandon its defense against the takeover and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its defense against the takeover, Y pays an investment banker \$1,000,000 for a second fairness opinion and for services rendered in negotiating with Z.

(ii) The legal fees paid by Y to seek an injunction against the takeover are not amounts paid in the process of investigating or otherwise pursuing the transaction with Z. Accordingly, these legal fees are not required to be capitalized under this section.

(iii) The investment banking fees paid to search for a white knight acquirer do not facilitate an acquisition of Y by a white knight because none of Y's costs with respect to a white knight were inherently facilitative amounts and because Y did not reach the date described in paragraph (e)(1) of this section with respect to a white knight. Accordingly, these amounts are not required to be capitalized under this section.

(iv) The amounts paid by Y to investigate and complete the recapitalization must be capitalized under paragraph (a)(4) of this section.

(v) The \$50,000 paid to the investment bankers for a fairness opinion during Y's defense against the takeover and the \$1,000,000 paid to the investment bankers after Y abandons its defense against the takeover are inherently facilitative amounts with respect to the transaction with Z and must be capitalized under paragraph (a)(3) of this section.

Example (12). Corporate acquisition; acquisition by white knight.

(i) Assume the same facts as in Example 11, except that Y's investment bankers identify three potential white knight acquirers: U corporation, V corporation, and W corporation. Y pays its investment bankers to conduct due diligence on the three potential white knight acquirers. On March 15, 2005, Y's board of directors approves a tentative acquisition agreement under which W agrees to acquire all of the stock of Y, and the investment bankers stop due diligence on U and V. On June 15, 2005, W acquires all of the stock of Y.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on U, V, and W prior to March 15, 2005 (the date of board of directors' approval) are not amounts paid to facilitate the acquisition of the stock of Y and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on W on and after March 15, 2005, facilitate the acquisition of the stock of Y and are required to be capitalized.

Example (13). Corporate acquisition; mutually exclusive costs.

(i) Assume the same facts as in Example 11, except that Y's investment banker finds W, a white knight. Y and W execute a letter of intent on March 10, 2005. Under the terms of the letter of intent, Y must pay W a \$10,000,000 break-up fee if the merger with W does not occur. On April 1, 2005, Z significantly increases the amount of its offer, and Y decides to accept Z's offer instead of merging with W. Y pays its investment banker \$500,000 for inherently facilitative costs with respect to the potential merger with W. Y also pays its investment banker \$2,000,000 for due diligence costs with respect to the potential merger with W, \$1,000,000 of which relates to services performed on or after March 10, 2005.

(ii) Y's \$500,000 payment for inherently facilitative costs and Y's \$1,000,000 payment for due diligence activities performed on or after March 10, 2005 (the date the letter of intent with W is entered into) facilitate the potential merger with W. Because Y could not merge with both W and Z, under paragraph (c)(8) of this section the \$500,000 and \$1,000,000 payments also facilitate

the transaction between Y and Z. Accordingly, Y must capitalize the \$500,000 and \$1,000,000 payments as amounts that facilitate the transaction with Z.

(iii) Similarly, because Y could not merge with both W and Z, under paragraph (c)(8) of this section the \$10,000,000 termination payment facilitates the transaction between Y and Z. Accordingly, Y must capitalize the \$10,000,000 termination payment as an amount that facilitates the transaction with Z.

Example (14). Break-up fee; transactions not mutually exclusive. N corporation and U corporation enter into an agreement under which U would acquire all the stock or all the assets of N in exchange for U stock. Under the terms of the agreement, if either party terminates the agreement, the terminating party must pay the other party \$10,000,000. U decides to terminate the agreement and pays N \$10,000,000. Shortly thereafter, U acquires all the stock of V corporation, a competitor of N. U had the financial resources to have acquired both N and V. U's \$10,000,000 payment does not facilitate U's acquisition of V. Accordingly, U is not required to capitalize the \$10,000,000 payment under this section.

Example (15). Corporate reorganization; initial public offering. Y corporation is a closely held corporation. Y'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 stock. The investment banking and legal services are performed both before and after board authorization. Under paragraph (a)(8) of this section, the \$5,000,000 is an amount paid to facilitate a stock issuance.

Example (16). Auction.

(i) N corporation seeks to dispose of all of the stock of its wholly owned subsidiary, P corporation, through an auction process and requests that each bidder submit a non-binding purchase offer in the form of a draft agreement. Q corporation hires an investment banker to assist in the preparation of Q's bid to acquire P and to conduct a due diligence investigation of P. On July 1, 2005, Q submits its draft agreement. On August 1, 2005, N informs Q that it has accepted Q's offer, and presents Q with a signed letter of intent to sell all of the stock of P to Q. On August 5, 2005, Q's board of directors approves the terms of the transaction and authorizes Q to execute the letter of intent. Q executes a binding letter of intent with N on August 6, 2005.

(ii) Under paragraph (e)(1) of this section, the amounts paid by Q to its investment banker that are not inherently facilitative and that are paid for activities performed prior to August 5, 2005 (the date Q's board of directors approves the transaction) are not amounts paid to facilitate the acquisition of P. Amounts paid by Q to its investment banker for activities performed on or after August 5, 2005, and amounts paid by Q to its investment banker that are inherently facilitative amounts within the meaning of paragraph (e)(2) of this section are required to be capitalized under this section.

Example (17). Stock distribution. Z corporation distributes natural gas throughout state Y. The federal government brings an antitrust action against Z seeking divestiture of certain of Z's natural gas distribution assets. As a result of a court ordered divestiture, Z and the federal government agree to a plan of divestiture that requires Z to organize a subsidiary to receive the divested assets and to distribute the stock of the subsidiary to its shareholders. During 2005, Z pays \$300,000 to various independent contractors for the following services: studying customer demand in the area to be served by the divested assets, identifying assets to be transferred to the subsidiary, organizing the subsidiary, structuring the transfer of assets to the subsidiary to qualify

as a tax-free transaction to Z, and distributing the stock of the subsidiary to the stockholders. Under paragraph (c)(3) of this section, Z is not required to capitalize any portion of the \$300,000 payments.

Example (18). Bankruptcy reorganization.

(i) X corporation is the defendant in numerous lawsuits alleging tort liability based on X's role in manufacturing certain defective products. X files a petition for reorganization under Chapter 11 of the Bankruptcy Code in an effort to manage all of the lawsuits in a single proceeding. X pays its outside counsel to prepare the petition and plan of reorganization, to analyze adequate protection under the plan, to attend hearings before the Bankruptcy Court concerning the plan, and to defend against motions by creditors and tort claimants to strike the taxpayer's plan.

(ii) X's reorganization under Chapter 11 of the Bankruptcy Code is a reorganization within the meaning of paragraph (a)(4) of this section. Under paragraph (c)(4) of this section, amounts paid by X to its outside counsel to prepare, analyze or obtain approval of the portion of X's plan of reorganization that resolves X's tort liability do not facilitate the reorganization and are not required to be capitalized, provided that such amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. All other amounts paid by X to its outside counsel for the services described above (including all amounts paid to prepare the bankruptcy petition) facilitate the reorganization and must be capitalized.

(m)Effective date. This section applies to amounts paid or incurred on or after December 31, 2003.

(n)Accounting method changes.

(1)In general. A taxpayer seeking to change a method of accounting to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446-1(e). For the taxpayer's first taxable year ending on or after December 31, 2003, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with this section, provided the taxpayer follows the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002-9 (2002-1 C.B. 327) and §601.601(d)(2)(ii)(b) of this chapter).

(2)Scope limitations. Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003.

(3)Section 481(a) adjustment. The section 481(a) adjustment for a change in method of accounting to comply with this section for a taxpayer's first taxable year ending on or after December 31, 2003 is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002.