

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Legend

- Taxpayer =
- New Parent =
- Taxpayer 1 =
- Taxpayer 2 =
- Taxpayer 3 =
- Taxpayer 4 =
- Group =
  
- Court =
  
- Investment Fund =
- Business A =
  
- Amount A =
- Amount B =
- Amount C =
- Prior Indebtedness 1 =
  
- Prior Indebtedness 2 =
  
- Prior Indebtedness 3 =

Exit Facility =  
a% =  
Year 1 =  
Date a =  
Date b =  
Date c =

Dear :

This letter is in response to a letter dated December 3, 2010, submitted on behalf of Taxpayer requesting rulings on the application of §§ 162, 165 and 263(a) of the Internal Revenue Code to various amounts expended in a bankruptcy reorganization.

### FACTS

Taxpayer was the parent of a consolidated group of which Taxpayer 1, Taxpayer 2, Taxpayer 3, and Taxpayer 4 were members (collectively, Group). Group filed consolidated tax returns on the calendar year basis and used an accrual method of accounting for federal income tax purposes.

Group engaged in Business A. Group was adversely affected by the economic downturn and on Date a, Group filed voluntary petitions for bankruptcy under Chapter 11 of title 11 of the United States Code with the Court. Contemporaneous with the filing of the bankruptcy petitions, Group filed a Chapter 11 plan (the "Plan"). The bankruptcy proceeding, including the sale of substantially all of the assets of Group and the liquidation of Group, will hereinafter be referred to as the "Transaction." As of Date a, Group had the following indebtedness outstanding: Prior Indebtedness 1, Prior Indebtedness 2, and Prior Indebtedness 3. The Investment Fund was a creditor with respect to Prior Indebtedness 2 and a portion of Prior Indebtedness 3. In connection with the bankruptcy filing, the Court approved a debtor-in-possession financing facility (the "DIP Facility") with a maximum borrowing capacity equal to Amount A. Group was the borrower under the DIP Facility. Group retired Prior Indebtedness 1 with proceeds from the DIP Facility.

#### A. The Transaction

Following a Court-approved auction in which the Investment Fund<sup>1</sup> was the successful bidder for Business A, the Court approved the Plan and the Asset Purchase Agreement ("Agreement"). The Plan and Agreement went into effect on Date b. Pursuant to the Plan and the Agreement, (i) the Investment Fund capitalized New

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<sup>1</sup> The investment advisor of the Investment Fund did not manage or control any of the partners of the partnership that owned Taxpayer before the commencement of the bankruptcy proceedings.

Parent by contributing Amount B, (ii) New Parent borrowed Amount C under the Exit Facility, (iii) New Parent transferred Amount B, Amount C, and a% of its common equity to Group and assumed certain liabilities of Group, and (iv) Group transferred substantially all of its assets to New Parent. Group then distributed the cash and the New Parent's equity to its creditors in cancellation of claims and liquidated on Date c. Of the creditors that could elect, under the Plan, to receive cash or New Parent's equity, only the Investment Fund elected to receive equity as a creditor of and in exchange for its portion of Prior Indebtedness 2. Thus, after the Transaction, the Investment Fund held all of the equity of New Parent, which borrowed approximately Amount C under the Exit Facility. The existing equity holders of Taxpayer did not receive any equity in New Parent, or rights to acquire such equity, or cash, or property in exchange for their equity interests in Taxpayer. In substance, the Investment Fund acquired substantially all of the assets of Group for cash and the cancellation of its claims and directed the assets to be transferred to New Parent. Taxpayer represents that this exchange of assets for New Parent's equity and cash constitutes a taxable exchange.

The cash proceeds described above were used to (i) pay in full the DIP Facility on Date b, (ii) pay in full the portion of the Prior Indebtedness 2 not held by the Investment Fund, (iii) pay, in part, the Prior Indebtedness 3, and (iv) pay certain transaction expenses. Taxpayer represents that Group liquidated pursuant to the Plan on Date c.

#### B. The Transaction Costs

Costs associated with the Transaction (collectively, the "Transaction Costs") were incurred on behalf of and for the benefit of Group. Taxpayer represents that the events that fixed the liability of Group for the Transaction Costs occurred in Year 1, and that the amount of such liabilities can be determined with reasonable accuracy in Year 1. Further, Taxpayer represents that none of the providers of services for which the Transaction Costs were incurred is a member of Group, and that the income reported by such service providers is not reported on the consolidated U.S. federal income tax return filed by Taxpayer for Group. In addition, Taxpayer represents that none of the providers of services for which the Transaction Costs were incurred has a relationship with Group specified in § 267(b), taking into account the constructive stock ownership rules of § 267(c).

The Transaction Costs are comprised of four basic types of costs incurred in Year 1 to facilitate the Transaction: (1) expenses that have been incurred in connection with the daily business operations conducted by Group prior to Date b ("Operational Expenses"); (2) expenses incurred as part of the sale of substantially all of Group's assets to New Parent (hereafter referred to as the "Asset Sale") in exchange for cash and New Parent's equity as part of the Plan ("Asset Sale Expenses"); (3) expenses incurred to institute or administer the bankruptcy proceedings ("Bankruptcy Administrative Expenses"); and, (4) expenses associated with Group's debt financing

(the “Debt Financing Expenses”). Each of these categories of expenses is described in greater detail below.

1. Operational Expenses

Group conducted business operations in Year 1 until Date b. During this time period, Group conducted its business operations and incurred expenses prior to its liquidation on Date c that it characterizes as Operational Expenses. These expenses, such as wages, compensation, payments for utilities, and overhead expenses were incurred in the ordinary course of Group’s daily business operations. Operational Expenses also included costs related to the leasing of equipment and facilities used by Group in conducting Business A. Taxpayer represents that Operational Expenses were incurred in Year 1 within the meaning of § 461, and that these expenses were regularly incurred by Group. Taxpayer further represents that Operational Expenses were a common or frequent occurrence in operating Group’s business, and that none of the Operational Expenses incurred in Year 1 produced an asset or benefit that extended beyond Group’s liquidation on Date c.

2. Asset Sale Expenses

Taxpayer also requests a ruling on the Asset Sale Expenses. In the course of the Transaction, Group sold substantially all of its assets and incurred liabilities in effecting the Asset Sale. These liabilities, the Asset Sale Expenses, include amounts incurred in furthering the Asset Sale generally and not amounts for the bankruptcy proceeding more generally. In particular, Asset Sales Expenses were amounts incurred for negotiating, drafting, and filing the agreements and documents that effectuated the asset sale, including amounts for negotiating, drafting, and filing of the Agreement with the Court. The Asset Sale Expenses also include amounts incurred for services to resolve compensation matters that arose as a result of the Asset Sale and for accounting and legal services related to the negotiating and drafting of portions of the Plan and the disclosure statement (to the extent it related to the Asset Sale) as well as other filings required to facilitate the sale of Taxpayer’s assets in the Transaction. Taxpayer represents that the sale of substantially all of its assets constitutes a taxable exchange that does not qualify as a tax-free reorganization within the meaning of § 368, and that the parties to the Transaction will treat the transfer as a taxable assets sale for federal income tax purposes.

3. Bankruptcy Administrative Expenses

Group incurred amounts to institute or administer the bankruptcy proceedings (“Bankruptcy Administrative Expenses”). These costs include expenses for the negotiation and drafting of the Plan and other documents required by the bankruptcy

proceedings, as well as for the reconciliation of creditors' claims and implementation of the automatic bankruptcy stay. The Bankruptcy Administrative Expenses were incurred on behalf of, and for the direct benefit of Group's bankruptcy estate. Taxpayer represents that with respect to claims asserted against Group by certain creditors of Group for professional fees and related costs under sections 503(b) and 506(b) of the Bankruptcy Code, Group made payments on such claims directly to the service providers with respect to which the claims arose. Taxpayer further represents that the Bankruptcy Administrative Expenses include neither amounts to resolve tort liabilities nor the Operational Expenses described above.

#### 4. Debt Financing Expenses

Group obtained Amount A in financing pursuant to the DIP Facility. In connection with the DIP Facility, Group incurred borrowing costs, including costs of negotiating the terms of and preparing filings related to the DIP Facility. Taxpayer refers to such expenses as the "Debt Financing Expenses." The DIP Facility was fully retired on Date b with distributions made from Group under the Plan.

### REQUESTED RULINGS

1. Operational Expenses incurred in Year 1 by Group are deductible under § 162.
2. Asset Sale Expenses incurred in Year 1 by Group are recoverable through the reduction of the amount realized by Group in the Asset Sale.
3. Bankruptcy Administrative Expenses incurred in Year 1 by Group are deductible upon the complete liquidation of Group in Year 1.
4. Debt Financing Expenses incurred in Year 1 by Group are deductible upon the retirement of the DIP Facility in Year 1.

### LAW AND ANALYSIS

As noted above, Taxpayer requests rulings on the federal income tax treatment of four categories of expenses: (1) Operational Expenses, (2) Asset Sale Expenses, (3) Bankruptcy Administrative Expenses, and (4) Debt Financing Expenses. The treatment of each category of expenditure is considered below. Taxpayer did not specifically identify or quantify these expenses. Consequently, we express no opinion on the determination of the amounts of expenditures or their classification. Further, we express no opinion on whether any particular expenditure is appropriately allocated to a particular category or any category at all. Determining how particular items are allocated among the four categories of expenditures is a question to be determined upon examination.

### 1. Operational Expenses

Taxpayer first requests a ruling that its Operational Expenses incurred in Year 1 are deductible under § 162. Section 162(a) provides generally a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 1.162-1(a) provides that deductible business expenses include ordinary and necessary expenditures directly connected with or pertaining to a taxpayer's trade or business. In Rev. Rul. 77-204, 1977-1 C.B. 40, the Service explained that the ordinary and necessary business expenses incurred by a bankruptcy trustee in the operation of a taxpayer's business during the pendency of bankruptcy proceedings were deductible under § 162 in the same manner and to the same extent they would have been if the bankruptcy proceeding had not been instituted. See also § 1.263(a)-5(c)(4). Based on Taxpayer's representations, Group's Operational Expenses are deductible by Group under § 162.

### 2. Asset Sale Expenses

Taxpayer next requests a ruling that the Asset Sale Expenses reduce the amount realized by Taxpayer from the sale of Taxpayer's assets in the Transaction. The treatment of these amounts is governed by § 263(a) which generally prohibits deductions for capital expenditures.

Section 1.263(a)-5(a)(1) provides that a taxpayer must capitalize an amount incurred to facilitate an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in or the target of the acquisition). In this case, the sale of Taxpayer's assets in the Transaction constitutes the sale of a business. Consequently, Taxpayer must capitalize amounts incurred to facilitate the sale in accordance with § 1.263(a)-5(a)(1).

Section 1.263(a)-5(g)(2)(ii)(A) provides that, in the case of an acquisition, merger, or consolidation that is not described in § 368 and that is treated as an acquisition of the assets of the target for federal income tax purposes, the seller must treat an amount required to be capitalized as a reduction of the seller's amount realized on the disposition of assets. In short, any such amount is taken into account as an adjustment to the amount realized under § 1001 with respect to the asset. Taxpayer has represented that the sale of Taxpayer's assets in the Transaction (1) is not described in § 368; (2) is a taxable transaction, and (3) will be treated as a taxable assets sale for federal income tax purposes by the parties to the Transaction. Accordingly, under § 1.263(a)-5(g)(2)(ii)(A) the Asset Sale Expenses reduce the amount realized by Group from the sale of Group's assets in the Transaction.

### 3. Bankruptcy Administrative Expenses

Taxpayer's third ruling request focuses on the treatment of the Bankruptcy Administrative Expenses. That is, on the treatment of amounts to administer the post-petition bankruptcy proceedings. Section 1.263(a)-5(c)(4) provides that an amount paid to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code by the taxpayer-debtor constitutes an amount paid to facilitate a reorganization. Such amounts are capitalizable under § 1.263(a)-5(a)(4) which provides that amounts incurred to facilitate a restructuring, recapitalization, or reorganization of the capital structure of a business entity must be capitalized. Group's Bankruptcy Administrative Expenses are amounts described in § 1.263(a)-5(c)(4) and are required to be capitalized under § 1.263(a)-5(a)(4).

Amounts required to be capitalized under § 1.263(a)-5 are deductible under § 165 when the transaction is abandoned. See Examples 3 and 4 of § 1.263(a)-5(l). Further, a corporation is permitted a loss for unrecovered capital expenditures upon the corporation's liquidation. Shellabarger Grain Products Co. v. Commissioner, 146 F.2d 177, 185 (7th Cir. 1944); Kingsford Co. v. Commissioner, 41 T.C. 646, 661 (1964) acq., 1964-2 C.B. 3. Similarly, Group is entitled to a loss under § 165 for its capitalized Bankruptcy Administration Expenses upon Group's liquidation in Year 1.

#### 4. Debt Financing Expenses

Taxpayer's last ruling request is on the deductibility of the Debt Financing Costs upon the retirement of the DIP Facility.

Section 1.263(a)-5(a) requires a taxpayer to capitalize amounts paid to facilitate certain changes in the capital structure of a business entity, including a borrowing, without regard to whether the transaction is a single step or a series of steps, or whether gain or loss is recognized. Section 1.263(a)-5(a)(9) defines a borrowing for purposes of § 1.263(a)-5(a) as any issuance of debt.

Section 1.263(a)-5(b)(1) provides that an amount is paid to facilitate a transaction described in § 1.263(a)-5(a) if the amount is paid in the process of investigating or otherwise pursuing the transaction, which is determined on the basis of all the facts and circumstances.

Section 1.263(a)-5(a)(4) generally requires capitalization of an amount paid to facilitate a restructuring, recapitalization, or reorganization of the capital structure of a business entity. Section 1.263(a)-5(c)(4) provides that, with certain exceptions, 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 § 1.263(a)-5(a)(4).

Under § 1.263(a)-5(c)(1), however, an amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing) described in § 1.263(a)-5(a). See also In Re Placid Oil Co., 988 F.2d 554, 559 (5th Cir. 1993).

Under § 1.263(a)-5(g)(4) and § 1.446-5(b), amounts capitalized with respect to a borrowing under § 1.263(a)-5 are treated (solely for purposes of determining the amount deductible in each period) as reducing the issue price and thereby creating or increasing OID (or reducing issuance premium).

If a loan is repaid prior to maturity, any unamortized portion of the capitalized costs generally is deductible. The unamortized portion may be deductible even if the loan is satisfied with proceeds of another loan from the same lender. See Buddy Schoellkopf Products v. Commissioner, 65 T.C. 640 (1975), acq. on this issue, 1981-2 C.B. 2 (fn. 9). In certain circumstances, the new loan is treated as an extension of the original loan and the capitalized costs of obtaining the first loan must be amortized over a period that includes the term of the second loan. See, e.g., Wilkerson v. Commissioner, 70 T.C. 240 (1978), rev'd on another issue, 655 F.2d 980 (9th Cir. 1981).

Any of the Debt Financing Expenses incurred to facilitate (within the meaning of § 1.263(a)-5(b)) Group's borrowing under the DIP Facility were required to be capitalized under § 1.263(a)-5(a) and, under § 1.263(a)-5(c)(1), did not facilitate any other transaction described in § 1.263(a)-5(a), including the Transaction. Upon the retirement of the DIP Facility in Year 1, the unamortized borrowing costs are not carried over to the Exit Facility, which was incurred by a different taxpayer, New Parent. Therefore, the amounts paid by Group in Year 1 to facilitate its borrowing under the DIP Facility were deductible upon the retirement of the DIP Facility in Year 1.

### CONCLUSIONS

1. Operational Expenses incurred by Group in Year 1 are deductible under § 162.
2. Asset Sale Expenses incurred by Group in Year 1, reduce the amount realized by Group in the Asset Sale in accordance with § 1.263(a)-5(g)(2).
3. The capitalized Bankruptcy Administrative Expenses incurred by Group during bankruptcy in Year 1 are deductible as losses under § 165.
4. Debt Financing Expenses to facilitate Group's borrowing, within the meaning of § 1.263(a)-5(b), are deductible upon the retirement of the DIP Facility.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

John P. Moriarty  
Chief, Branch 1  
(Income Tax & Accounting)

cc: