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COVID-19 Tax Insights—Current Cash Refund for Costs of Abandoned Transactions

First in a Three Part Series on Capital Transaction Costs

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Businesses that cancel transactions may be able to take loss deductions for costs incurred in connection with those abandoned transactions to the extent the costs were not already deductible; the losses may be carried back and potentially generate tax refunds.

In the wake of the COVID-19 crisis, America has cancelled just about everything; the President has declared the COVID-19 a federal disaster and the entire country to be a federally declared disaster area.[1] Among the cancelled activities likely are numerous acquisitive and capital oriented business transactions, for which taxpayers already may have incurred significant expense. As described in this

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[1] On March 13, 2020, the President issued an emergency declaration for all states, tribes, territories, and the District of Columbia to respond to COVID-19 pursuant to section 501 (b) of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, 42 U.S.C. 5121-5207 (the "Stafford Act"). *See* FEMA Release HQ-20-017-FactSteet (Mar. 13, 2020), https://www.fema.gov/news-release/2020/03/13/covid-19-emergency-declaration

article, taxpayers may be able to take a section 165(a) [2] loss for costs incurred in connection with such abandoned transactions to the extent that the costs were not already deductible. [3]

Moreover, because of the President's disaster declaration, section 165(i) may apply to permit a taxpayer to carry that loss back to the year preceding the year in which the taxpayer incurred the loss. Accordingly, if the taxpayer has a current year section 165(a) deduction for costs of an abandoned transaction, is eligible for section 165(i), and paid tax in the year preceding the year that it abandoned the transaction, it may carry the section 165(a) abandoned transaction loss back to the previous year and file for a refund. In addition, on March 28, 2020, the President signed the Coronavirus Aid, Relief, and Economic Security Act (the "**CARES Act**"), that enacted, in relevant part, section 172(b)(1)(D), which permits taxpayers to carry back certain net operating losses ("**NOLs**") up to five years. Accordingly, if the costs resulting from an abandoned transaction would create or increase an NOL, a taxpayer may be able to carry such costs back for five years. Because the economy in prior years had been doing relatively well, it is likely that carrying back the loss would generate a refund for many taxpayers, creating an opportunity to generate cash that may be helpful for an enterprise to weather the COVID-19 crisis. Because the new NOL carryback is for a five-year carryback period, the loss carryback in many cases will result in a permanent tax benefit by offsetting income that was taxed at the higher marginal rates in effect through 2017.

This article first will consider the scope of the 165(a) deduction for abandoned transactions and then focus on the application of the section 165(i) and section 172(b)(1)(D) carryback provisions. We note that this merely is an overview of the potentially applicable rules highlighting potential opportunities.

Section 165 Deduction for Abandoned Transactions

Section 165(a) allows a taxpayer to deduct "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

Cases, revenue rulings, and regulations long have concluded that a taxpayer may take a deduction under section 165 or its predecessors for costs incurred to facilitate a transaction upon the abandonment of that transaction.[4]

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[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[3] While this article focuses on acquisitive and capital transactions, a taxpayer may be eligible to take a section 165(a) deduction with respect to the capitalized portion of the costs to facilitate a variety of other abandoned business transactions, such as entering into a lease or a services contract. The abandoned transaction authorities cited infra for business transactions in general appear equally applicable in this context. On the other hand, whether payments to terminate an existing services, supply, or lease contract could be deductible under section 165(a) will depend on the circumstances.

[4] *See, e.g.,* Sibley, Lindsay & Curr Co. v. Commissioner, 15 T.C. 106 (1950), *acq.* 1951-1 C.B. 3; Portland Furniture Mfg. Co. v. Commissioner, 30 B.T.A. 878 (1934); Doernbecher Mfg. Co. v. Commissioner, 30 B.T.A. 973 (1934), *acq.* XIII-2 C.B. 6, *aff'd*, 80 F.2d 573 (9th Cir. 1935); Tobacco Products Export Corp. v. Commissioner, 18 T.C. 1100 (1952); Larsen v. Commissioner, 66 T.C. 478 (1976); Rev. Rul. 67-125, 1967-1 C.B. 31; Rev. Rul. 73-580, 1973-2 C.B. 86; Rev. Rul. 79-2, 1979-1 C.B. 98; section 1.165-2(a); section 1.263(a)-5(l), *Example (3)(iii)* and *(iv)*, *Example (4)(iv)*.

However, as section 165 requires taxpayers to prove that an asset becomes worthless rather than merely declining in value, taxpayers must be able to show that they have in fact abandoned their transaction. In this space, there is tension between the situation where a taxpayer has abandoned its transaction compared to that where it merely postpones it. The Internal Revenue Service (the "**Service**") has pushed back on a taxpayer's deduction for an abandoned transaction where the Service concludes under the facts that the taxpayer merely postponed the transaction rather than abandoned it.[5]

However, this resistance should not be interpreted automatically to preclude a section 165 deduction where a taxpayer abandons a transaction and later ends up consummating the same (or a similar) transaction. Several courts have held that a taxpayer would not be precluded from deducting costs incurred to facilitate an abandoned transaction merely because it later consummated a similar transaction (even if it used some of the diligence from the abandoned transaction in the consummated transaction) provided that it can show that it truly intended to abandon the initial transaction.[6]

The takeaway here is that a taxpayer seeking to deduct costs for an abandoned transaction must show its intention to abandon rather than postpone the transaction during the tax year it seeks to claim the deduction. As is so often the case, the resolution of this issue in a given case would depend on the facts and circumstances and the sufficiency of the evidence. An intervening event causing the transaction no longer to constitute a favorable proposition—such as threat of a shutdown of the global economy due to COVID-19 for the foreseeable future—could constitute such evidence. Other supporting evidence could include public statements articulating intent of the parties not to go forward, direction to the service providers not to continue work on the project, board resolutions to terminate the transaction, recall of diligence materials and cut off of data room access, and pulling any relevant SEC registrations. However, statements indicating that the parties intend a temporary pause in their process could be viewed as evidence of postponement rather than abandonment.

Costs Subject to Section 165(a)

As an overview, regulations require taxpayers to capitalize certain costs incurred to investigate or otherwise pursue a variety of transactions,[7] while also providing that taxpayers are not required to

5 For example, in a Non Docketed Service Advice Review, the Service refused to permit a taxpayer to deduct costs for an "abandoned" offering of stock because it concluded that the facts indicated that it was postponing rather than abandoning the offering. 2013 IRS NSAR 3101F (Aug. 2. 2013).

6 Portland Furniture Mfg. Co. v. Commissioner, 30 B.T.A. 878 (1934); Doernbecher Mfg. Co. v. Commissioner, 30 B.T.A. 973 (1934), *acq.*, XIII-2 C.B. 6, *aff'd*, 80 F.2d 573 (9th Cir. 1935).

7 A number of provisions require taxpayers to capitalize amounts paid to service providers who facilitate (defined by section 1.263(a)-4(e)(1)(i) and section 1.263(a)-5(b)(1) to be to investigate or otherwise pursue) certain types of transactions. Section 1.263(a)-5(a) requires taxpayers to capitalize costs incurred to facilitate a variety of acquisitive, capital, and restructuring transactions. Section 1.263(a)-4(b)(1)(i) and (v), (c), and (e) require taxpayers to capitalize costs to facilitate the acquisition of ownership interests in a variety of instruments, including non-controlling ownership interests in a corporation or partnership, also interests in a trust, estate, limited liability company, or other entity and debt instruments and related instruments, to the extent that section 1.263(a)-5 doesn't otherwise require such capitalization. Section 1.263(a)-4(b)(1) and (v), (d), and (e) also require taxpayers to capitalize costs to facilitate a variety of other transactions such as amending instruments and acquiring, creating, or amending certain contract rights and provide exceptions to such capitalization.

capitalize a variety of other costs incurred in connection with such transactions.[8] For example, taxpayers participating in certain types of acquisitive transactions ("**Covered Transactions**") capitalize costs only if they fall on or after a defined date on the timeline of the transaction (the "**Bright Line Date**") or on an exclusive list of particularly facilitative costs ("**Inherently Facilitative Costs**") whenever incurred.[9] Generally, taxpayers or their advisors review a variety of documentation, including invoices, engagement letters, and work product, and sometimes interview service providers, to support the allocations required by these rules.

While a detailed look at these rules is beyond the scope of this article, examples in the regulations make clear that these rules apply to costs incurred to facilitate an abandoned transaction.[10] The importance of the application of these rules to the costs of an abandoned transaction is that costs otherwise not required to be capitalized would continue to be deductible in the year that they are incurred under section 162 or amortized under section 195, to the extent that they would have been so deducted or amortized had the taxpayer consummated the transaction. Section 165(a) likely would not apply to costs that the taxpayer paid for services and was not required to capitalize into the consummated transaction.[11]

Let's consider an example:

- Corporation X incurs costs to investigate or otherwise pursue an acquisition of all of the stock of corporation T,
- The acquisition if consummated would constitute a Covered Transaction,
- X does not reach a Bright Line Date for the acquisition and does not incur any Inherently Facilitative Costs in connection with such transaction; and
- X abandons the acquisition of T.

[8] *See e.g.*, section 1.263(a)-5(e) (taxpayer that incurs costs to facilitate a Covered Transaction defined in section 1.263(a)-5(e)(3) will treat such costs as facilitative costs that must be capitalized only if it incurs them on or after the Bright Line Date defined in section 1.263(a)-5(e)(1) or if they are on an exclusive list of Inherently Facilitative Costs defined in section 1.263(a)-5(e)(2); section 1.263(a)-5(d)(2) (taxpayer not required to deduct compensation amounts even if they facilitate a Capital Transaction); section 1.263(a)-5(c)(6) (taxpayers not required to capitalize amounts incurred for integration services incurred in connection with a Capital Transaction).

[9] *See* sources cited *id.*

[10] *See, e.g.*, section 1.263(a)-5(l), *Example 12(ii)* and *Example 13(ii).*

[11] Section 1.263(a)-5(l), *Example (3)(iv)*, addresses this point. In the example, in relevant part, the taxpayer paid $500,000 to facilitate (defined by section 1.263(a)-5(b)(2) to be to investigate or otherwise pursue) Covered Transactions in which the taxpayer either would be the buyer or the target and later abandoned the transactions. The regulation acknowledged that the taxpayer would be required to capitalize those costs incurred on or after the Bright Line Date and costs that were Inherently Facilitative Costs, whenever incurred. The example concluded that the taxpayer may deduct under section 165 any portion of the $500,000 that was paid to facilitate the transaction. We believe that the more likely interpretation of this regulation is that the taxpayer would be permitted a section 165 deduction for the portion of the $500,000 reflecting its on-or-after Bright Line Costs and its Inherently Facilitative Costs, the portion of the costs treated as facilitating the transaction under the section 1.263(a)-5(e) Covered Transaction regime.

An example in the regulations concludes that X would be required not to capitalize its pre-Bright Line Date non-Inherently Facilitative Costs with respect to the acquisition of X under general principles, thus it would be able to deduct such costs under section 162 or amortize them under section 195 to the extent that it could have done so had X actually undertaken the acquisition. On the other hand, X would have been required to capitalize its on-or-after Bright Line Date costs and any Inherently Facilitative Costs in the Covered Transaction. When X abandons the transaction, it may be able to deduct these capitalized costs under section 165(a) subject to the issues that we discuss, below.

The takeaway here is that a taxpayer or its advisors need to consider the structure of the abandoned transaction and the nature of each of the costs incurred, as some of the costs would be deductible under section 162 or amortized under section 195 regardless of whether the transaction was abandoned and other costs potentially would be deductible upon abandonment under section 165(a). As we discuss below, that distinction would affect the ability of a taxpayer to carry such deductions back under section 165(i) or under section 172(b)(1)(D).

Capital or Ordinary Loss

In a case where a corporate taxpayer[12] does not receive anything in exchange for the asset averred to be worthless, section 165(a) generally permits a taxpayer to take an ordinary rather than a capital loss.[13] Accordingly, as a general proposition, the section 165(a) loss for abandoned transactions constitutes an ordinary loss. However, in relevant part, section 1234A requires taxpayers to treat a gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to a capital asset as a capital loss. This provision only applies if there is a termination of right to acquire property; accordingly, if parties are working on a transaction but have not yet entered into a

[12] In the case of a partnership claiming an ordinary deduction under section 165(a) and such loss is allocated to individual taxpayers, the partners may not realize a tax benefit from the loss. Section 165(c) limits an individual's losses under section 165(a) to losses (a) incurred in a trade or business; (b) incurred in a transaction entered into for profit, though not connected with a trade or business; and (c) losses which do not arise from a trade or business, or activity entered into for profit, but nevertheless arise from certain casualties or theft. Section 62 defines itemized deductions as deductions allowed under Chapter 1 of the code other than deductions allowable in arriving at adjusted gross income, personal exemptions, and the section 199A deduction. Section 67 defines a "miscellaneous itemized deduction" as an itemized deduction other than a list of specific deductions such as real property taxes and charitable contributions. The list of deductions does not include a deduction for losses incurred in a transaction entered into for profit (other than an exception for certain casualty or theft losses). As such, a section 165(c) loss which is not from a casualty or theft or incurred in a trade or business is a miscellaneous itemized deduction. Miscellaneous itemized deductions are disallowed through 2025 under current law.

[13] While section 165 does not specifically state that a deduction thereunder would be an ordinary rather than a capital loss as a general matter, it can be inferred from the fact that section 165 does have specific provisions that to require the loss to be capital in certain circumstances. *See, e.g.*, section 165(f) (losses from sales or exchanges of capital assets must be treated under 1211 and 1212); section 165(g) (taxpayer required to recognize a capital loss upon the worthlessness of stocks or securities, unless the holder and the issuer satisfy certain requirements described in section 165(g)(3)); section 1.165-5(i) (losses resulting from abandonment of stocks or securities must be treated as worthless securities subject to section 165(g)(3)).

binding agreement to consummate the transaction, section 1234A cannot apply to the loss. [14] Also, the Service has taken the position that this provision would apply to costs incurred in connection with an abandoned acquisitive transaction that involves the termination of an agreement and further has applied the provision to costs incurred by a target in a stock acquisition.[15] Finally, because this provision characterizes gains and losses, it likely only would recharacterize those amounts paid to service providers that would constitute a loss under section 165(a) (e.g., in a Covered Transaction, costs incurred on or after the Bright Line Date and Inherently Facilitative Costs).[16]

The takeaway here is that the character of the loss deduction under section 165(a) for an abandoned transaction may depend in part or in whole on whether the abandonment was attributable to the termination of an agreement to undertake the transaction.

Facilitation of Subsequent Transaction

The rules become more complex when the abandoned transaction is followed by another transaction. Under certain circumstances, the capitalized costs of the abandoned transaction may have to be capitalized into the consummated transaction rather than deducted under section 165(a) as described above.

In relevant part, section 1.263(a)-5(c)(8) provides that an amount paid to facilitate a capital transaction described in section 1.263(a)-5(a) is treated as an amount paid to facilitate a second such capital transaction only if the transactions are mutually exclusive.[17] Under this rule, if transactions are not mutually exclusive, the capitalized costs of the abandoned transaction may not be capitalized into the consummated transaction. However, if the transactions are mutually exclusive, the costs of the abandoned transaction potentially may be capitalized into the consummated transaction, depending on other considerations.[18]

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[14] Pilgrim's Pride v Commissioner, 779 F.3d 311 (5th Cir. 2015), clarifies that section 1234A requires the termination of a right to acquire property. Accordingly, it would not apply if the transaction were abandoned but there was no termination of an acquisition agreement.

[15] *See* CCA 201642035 (Feb. 9, 2016).

[16] See discussion of section 1.263(a)-5(l), *Example (3)(iv)*, in note 11.

[17] It is not clear what "mutually exclusive" means within the meaning of this rule. It may mean structural mutual exclusivity, where a taxpayer could not consummate two transactions as a structural matter. *See e.g.*, section 1.263(a)-5(l), *Example (4)*. Or, it may mean practical exclusivity, where the taxpayer could not as a business matter consummate both transactions. *See. e.g.*, section 1.263(a)-5(l), *Example (3)*. A discussion of this issue is beyond the scope of this memorandum.

[18] The preamble to the final regulations gives some insight as to the circumstances under which the costs of the abandoned transaction may be capitalized into the consummated transaction in the event of mutual exclusivity, stating that "an amount paid to facilitate a transaction described in the regulations is treated as facilitating a second transaction described in the regulations only if the transactions are mutually exclusive and the first transaction is abandoned to enable the taxpayer to engage in the second transaction". *See* T.D. 9107, 69 Fed. Reg. 436 (Jan. 5, 2004). Case law also supports this distinction. *Compare* Tobacco Products Export Corp. v. Commissioner, 18 T.C. 1100, 1102 (1952) (court permitted a deduction where the taxpayer incurred costs to consider one alternative, rejected it, and turned toward subsequent proposals, noting that "[e]ach plan was presented as a new proposal when the preceding one was rejected," rather than "alternative proposals presented to petitioner for it to choose between"), *with* Hillsborough Holdings Corp. v. United States, 85 AFTR2d 2000-1818, 1824 (Bankr. M.D. Fla 2000) (court denied a taxpayers claim of a deduction for an abandoned transaction where the

This issue may not be a concern where a taxpayer abandons a transaction because of COVID-19 and does not have a Plan B transaction in the wings. However, because of the facts and circumstances nature of this area, ambiguity in the rules, and case law beyond the scope of this overview discussion, evaluating the deductibility of these costs often can be unexpectedly complex.[19]

Section 165(i)

Section 165(i) permits a taxpayer[20] to elect to treat a section 165(a) loss occurring in a disaster area and attributable to a federally declared disaster as occurring in the tax year immediately preceding the tax year in which the loss occurred. Section 165(i)(5) defines a "federally declared disaster" to be any disaster subsequently determined by the President to warrant assistance by the federal government under the Stafford Act. Moreover, section 165(i) is not limited to casualty losses. Rather, it applies to any loss (except as otherwise excluded by the provision) for which a section 165(a) loss would be available.[21] Accordingly, section 165(i) could apply to an abandoned transaction loss. Section 1.165-11 and Revenue Procedure 2016-53, 2016-44 I.R.B. 530, provide procedures for making and revoking a section 165(i) election.

On March 13, 2020, the President declared the entire nation to be a federally declared disaster area under the Stafford Act due to COVID-19. Accordingly, section 165(i) is available for losses for abandoned transactions. In addition to the proof necessary to support a deduction under section 165(a) generally, in order to use this carryback provision, a taxpayer must show that the loss occurred within the United States and was attributable to COVID-19.

Significantly, section 165(i) only would apply to those costs that otherwise would be deductible under section 165(a). Accordingly, it only would permit taxpayers to carry back amounts paid to service providers in an abandoned transaction that would have been capitalized under sections 1.263(a)-4 and -5, but presumably would not apply to those amounts paid to service providers not required to be capitalized that may be deductible under section 162 or amortizable under section 195.[22]

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taxpayer simultaneously considered several alternate transactions, choosing one to consummate). Nevertheless, other case law beyond the scope of this memorandum can be interpreted to leave the scope of this rule unclear.

[19] As noted above, individual partners in a partnership claiming an ordinary loss under section 165(a) may not realize a tax benefit of such loss. As such, it may be preferable that the transaction be postponed, as opposed to abandoned, or that the abandoned transaction is mutually exclusive with a second transaction that is consummated.

[20] If the taxpayer is a partnership, additional considerations are required including but not limited to making the election, determining the amount and allocation of the loss, and procedural requirements to claim the loss. Depending on a partnership's facts and circumstances, it may not want to make an election under section 165(i). Additional discussion on the application of section 165(i) to partnerships and its partners is beyond the scope of this article.

[21] The preamble to amendments to section 1.165(a)-11 clarify this point. *See* T.D. 7522, 42 Fed. Reg. 63410 (Dec. 16, 1977).

[22] The limitation of the section 165(i) carryback to section 165(a) losses turns the typical leaning of transaction cost analysis on its head. More typically, taxpayers are incented to try to characterize transaction costs as deductible rather than capitalized. However, because section 165(i) only applies to the costs that would have been capitalized in the transaction, taxpayers are incented thereunder to find costs to be capitalizable rather than deductible or amortizable under provisions to which section 165(i) does not apply. However, newly enacted section 172(b)(1)(D), discussed below, may preserve the current leaning to deduct such costs.

If the losses to be carried back under section 165(i) are capital losses pursuant to section 1234A, such losses are not as likely to generate a refund for the taxpayer in that prior year as a carry back of other losses that are not limited to offsetting capital gains.[23] However, as capital losses, for a corporation, if they cannot be used in the year in which they are incurred, section 1212 permits a corporate taxpayer to carry them back to three years preceding the loss year.

These rules suggest that taxpayers may undertake planning to affect the ability to use the losses generated by an abandoned transaction. For example, section 1.263(a)-5(d)(4) permits taxpayers to elect whether to capitalize employee compensation, overhead, and de minimis costs that facilitate the transaction. Electing to capitalize such costs could permit taxpayers to carry them to the prior year pursuant to section 165(i).

Taxpayers may be able to increase the amount of their abandoned transaction cost loss potentially eligible for section 165(i). While taxpayers entering into deals generally capitalize only costs that are required to be capitalized, section 1.263(a)-5(d)(4) allows taxpayers on a transaction-by-transaction basis and year-by-year basis to capitalize certain costs that would be facilitative, but that are not required to be capitalized by reason of the safe harbor for employee compensation, overhead, and de minimis costs. Because this is a year-by-year election, a taxpayer could consider making this election for the 2020 tax year to increase the amount of costs that would be part of the loss deduction and eligible to be claimed in 2019 (under section 165(i) or section 172(b)(1)(D). On the other hand, if the loss carryback under section 172(b)(1)(D) is preferred over section 165(i), or the character of the loss could be capital (as discussed below), then the election may not offer an advantage over claiming current deductions.

New Section 172(b)(1)(D)

As described above, the CARES Act, among other changes, added section 172(b)(1)(D) to permit a five-year carryback of NOLs for NOLs incurred in tax years beginning after December 31, 2017, and before January 1, 2021. Similar in concept to section 165(i), section 172(b)(1)(D) would permit taxpayers to monetize the current year's net operating loss by carrying it back to a prior year with taxable income and filing for a refund of taxes for that year.

Under this rule, if treating costs as deductible would create or increase a net operating loss for the year, it may be more desirable to characterize costs as deductible and subject to a five-year carry back than it would be to capitalize them and subject them to the one-year section 165(i) carryback.[24] An evaluation of all of the changes made by the CARES Act regarding losses is beyond the scope of this article.

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[23] While section 1212 permits a corporate taxpayer to carry back a net capital loss for three years, it only applies if the taxpayer has a net loss in the year of the loss and if the carryback of the loss does not increase or produce a net operating loss in the year to which it is carried back. Presumably, the section 165(i) carryback provision would not be subject to the 1212 limitations.

[24] For example, if a deduction would create or increase an NOL such that it would be subject to a section 172(b)(1)(D) five-year carryback, a taxpayer may not want to elect under section 1.263(a)-5(d)(4) to capitalize certain costs.

What Can We Do to Help?

COVID-19 likely will cause the cancellation or postponement of numerous transactions. Section 165(a) gives taxpayers an opportunity to deduct certain costs incurred in connection with cancelled transactions. Section 165(i) and section 172(b)(1)(D) present taxpayers with an opportunity to monetize these deductions by allowing them to carry them back to prior, likely more prosperous, years. Taxpayers should document the facts around the transaction and the underlying costs to best position them to take advantage of this opportunity. As discussed above, the application of these provisions often requires extensive factual development and resolution of technical issues, including the need to characterize costs as a factual matter under the transaction cost rules generally (e.g., whether a transaction is "abandoned"; in a Covered Transaction, whether costs are Inherently Facilitative Costs or otherwise incurred on or after the Bright Line Date), how to treat costs for an abandoned transaction followed by a consummated transaction, the potential application of section 1234A, as well as ancillary considerations such as whether the taxpayer will have a potential NOL for the current year. KPMG is able to help taxpayers resolve these factual and technical issues in the case of costs for an abandoned transaction and help them optimize their ability to potentially generate a refund under section 165(i) or section 172(b)(1)(D).

For further information, please contact Carol Conjura, Debbie Fields, Megan Fitzsimmons, John Geracimos, Eric Lee, William McCanless, Shane Rushing, or Jarod Wall.

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