CCH
a Wolters Kluwer business

The M&A Tax Report

OCTOBER 2012 VOLUME 21, NUMBER 3

The Monthly Review of Taxes, Trends & Techniques

Documenting Deal Cost Deductibles

By Robert W. Wood • Wood LLP • San Francisco

Taxpayers are generally required to capitalize amounts that are paid to facilitate corporate acquisitions. In fact, this rule applies to any collection of assets that constitute a trade or business. This is true whether the taxpayer is the target or the acquirer. [*See* Reg. §1.263(a)-5(a).]

In the lion's share of cases, it can be clear what goes into the less attractive category of items that must be capitalized. "Facilitate," in this context, typically refers to amounts that are paid in the process of investigating or otherwise pursing the transaction. [*See* Reg. §1.263(a)-5(b).] Amounts paid to determine the value or pricing of the target are certainly included within this category.

Thus, these amounts should be capitalized. However, not all costs incurred by an acquirer (or target) are *necessarily* facilitative. Reg. §1.263(a)-5 provides rules allowing for the deduction of certain costs despite their facilitative character. Conversely, some costs are viewed as "inherently facilitative" and therefore always in the capitalize column.

Such "inherently facilitative" costs can never be deducted, regardless of when they are incurred. These costs include the following:

- Securing an appraisal, a formal written evaluation or a fairness opinion related to the transaction
- Structuring the transaction, including negotiating the structure and obtaining tax advice on the structure (for example, on the application of the reorganization provisions)
- Preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement and all that goes with it)
- Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings

ALSO IN THIS ISSUE

- Obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs and costs to promote the transaction to shareholders)
- Conveying property between the parties to the transaction (for example, transfer taxes and title registration costs) [*See* Reg. §1.263(a)-5(e)(2).]

But putting these inherently facilitative costs to the side, an amount generally facilitates a deal only after a signed letter of intent or the communication of deal terms of a similar nature is issued. The idea is that a capitalization line is drawn once the material terms of the transaction are approved by the taxpayer's board of directors. [*See* Reg. §1.263(a)-5(e).] This means you can deduct costs paid to determine the value or price of the transaction as long as they are incurred before the letter of intent is executed or the board of directors signs off on the deal.

The M&A Tax Report
The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Farley

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

Success-Based Fees

With this background, you might assume that fees paid on the consummation of the deal *always* facilitate it and therefore must always be capitalized. Yet Reg. §1.263(a)-5(f) provides a window that can, at times, be bigger than a door. When an amount is paid that is contingent on the successful closing of a transaction, it is deductible to the extent that the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the closing itself.

In other words, you can deduct it if you can prove it. Documentation is key. The documentation of the nonfacilitative character of the contingent fee is usually based on time records, itemized invoices and other records that identify the following:

- The various activities performed by the service provider
- The amount of the fee (or percentage of time) that is allocable to each of the various activities performed
- The amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after a particular date, where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction
- The name, business address and business telephone number of the service provider [*See* Reg. §1.263(a)-5(f).]

Interestingly, unlike some other record-keeping obligations, these rules include a contemporaneousness requirement. The documentation supporting the deduction needs to be completed by the time the taxpayer files its (original, not amended) tax return for the year the transaction closes.

Types of Records

A good example of the nitty gritty of this rule appears in TAM 201002036 (Sept. 21, 2009). In the TAM, a company sought to deduct a portion of the success-based contingent fees it paid to investment bankers pursuant to a merger. The taxpayer hoped to substantiate the deduction based on spreadsheets containing certain general records of the work performed by the investment bankers before the merger was approved by the taxpayer's board.

Unfortunately, though, the taxpayer had no time records or itemized invoices to substantiate the allocation between the facilitative and nonfacilitative work the investment bankers did. Some expenses aided the deal; others did not. The spreadsheets had been prepared by the taxpayer's accountants.

The taxpayer argued they qualified as "other records" that adequately substantiated the two classes of work done by the investment bankers. Predictably, though, the IRS was not a pushover. The IRS's Large & Mid-Sized Business (LMSB) Division argued that the spreadsheets were not "other records" sufficient to prove that some of the success-based fees were attributable to nonfacilitative activities.

In the end, the taxpayer's view prevailed. The TAM concludes that time records, itemized invoices or other documents can suffice. The type of document and what you call it is not as important as the attention to detail required in it. Of course, contingent fees, by their nature, cannot be assessed until after the deal has closed.

Plainly, substantiating deductions can be tedious. However, taxpayers should retain detailed records of every expense incurred in the transaction. Despite the general rules and the predisposition of the IRS to see everything capitalized, not everything goes into that category.