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Documenting Deductible Deal Costs

By Christopher A. Karachale • Wood & Porter • San Francisco

Mergers are complex transactions, involving many parties. Aside from the entities doing the merging, that means investment bankers, accountants, lawyers and consultants. Attention to detail can often make or break such deals. That may be true across a wide array of disciplines, but from a tax standpoint, meticulous record-keeping is particularly important.

The protagonist of recently deceased J.D. Salinger's CATCHER IN THE RYE did not want to recount "all that David Copperfield kind of crap." Nevertheless, it behooves taxpayers to be able to substantiate *every* cost. That means from the beginning of the transaction to the end. Taxpayers who don't may end up with a capital expense that could have been deducted in the year of the transaction.

Deduction for Costs That Don't Facilitate

In general, a taxpayer must capitalize amounts paid to facilitate the acquisition of assets that constitute a trade or business. That's so whether the taxpayer is the target or acquirer. [*See* Reg. §1.263(a)-5(a).] "Facilitate" in the context of corporate mergers typically refers to amounts that are paid in the process of investigating or otherwise pursing the transaction. [*See* Reg. §1.263(a)-5(b).]

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. That means it should be capitalized. However, not *all* costs incurred by an acquirer (or target) are necessarily facilitative, which means that not all costs must be capitalized. Reg. §1.263(a)-5 provides rules allowing for the deduction of certain costs despite their facilitative character.

Except for certain "inherently facilitative" costs, an amount paid by a taxpayer in the process of investigating or otherwise pursuing a typical merger transaction facilitates the transaction *only if* it relates to activities performed *on or after* the earlier of the date of a letter of intent or a

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similar communication is executed or the date on which the material terms of the transaction are authorized or 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 such expenses are incurred *before* the letter of intent is executed or the board of directors signs off on the deal.

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

- Securing an appraisal, formal written evaluation or fairness opinion related to the transaction
- 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 Code Sec. 368)
- Preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement)
- Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings
- 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).]

These rules make sense. If you incur certain costs before the bright-line date the merger is approved, such costs are deductible because they are not facilitative. However, the Treasury Regulations have carved out a class of costs that are *never* deductible. These "inherently facilitative" costs appear to meet some threshold that makes them "capital" enough that they should not be deductible.

Deduction for Success-Based Fees

A second and more enigmatic deduction is allowed for taxpayers engaged in a merger. Reg. §1.263(a)-5(f) provides that where an amount is paid that is contingent on the successful closing of a transaction, it is deductible 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 Regulation appears to have been implemented to allow taxpayers to deduct the contingent fees often charged by investment banks and others as part of a transaction.

The documentation of the nonfacilitative character of the contingent fee can be burdensome. But there's no gain without pain, as they say. A taxpayer must maintain "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

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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).]

Timing matters too. This documentation needs to be completed on or before the date the taxpayer's original federal return is filed for the year in which the transaction closes. [*See id*.]

The problem, at least until recently, was that the relationship between the general bright-line rule for deducting nonfacilitative costs incurred before the deal was approved, and the documentation requirement for success-based fees was not entirely clear. After all, Reg. §1.263.1(a) was only finalized at the end of 2003. [*See* 69 FR 436 (Jan. 1, 2004).]

Facile Facilitating

TAM 201002036 (Sept. 21, 2009) provides some well-reasoned and helpful insight into the substantiation requirements that allow a taxpayer to deduct contingent-based fees that are not facilitative. In the TAM, a taxpayer corporation sought to deduct a portion of the success-based contingent fees 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 of directors.

The TAM provides guidance on two important points. First, it clarifies the documentation requirement for success-based fees. Second, it discusses how contingent fees interact with the bright-line rule for nonfacilitative costs.

Document Your Deduction

TAM 201002036 points out that the taxpayer could not produce "time records" or "itemized invoices" that would substantiate the allocation between the facilitative work the investment bankers did (on the one hand) and the non-facilitative work (on the other). Some expenses aided the deal, while some did not. The question then was whether the spreadsheets (which had been prepared by the taxpayer's accountants) constituted "other records" that would adequately substantiate the nonfacilitative work done by the investment bankers.

The Large & Mid-Sized Business (LMSB) Division argued that such spreadsheets were not "other records" sufficient to prove that some of the success-based fees were attributable to nonfacilitative activities. However, the National Office voiced a more *laissez-faire* view. It ruled that *any* document, whether labeled a "time record" or "itemized invoice", can serve to establish the deductible portion of a success-based fee.

Tax advisors facing a pending deal had better be sure to ask up front what kind of options are in the mix.

According to the National Office: "What is important is whether the documents presented, taken as a whole, provide the information required by" Reg. §1.263(a)-5(f). This holistic approach means that almost any record can be used to show the allocation of contingent fee work to nonfacilitative costs. Of course, it doesn't mean everything is deductible. But the TAM does help to demonstrate that the type of document is not so important as the attention to detail required of the document when it comes to substantiating the deduction.

Facilitative Investment Banking

The TAM acknowledges that the investment bankers engaged in activities that were nonfacilitative and those activities occurred before the date the acquisition was approved by the taxpayer's board of directors. In assessing the deductibility of contingent fees that are adequately substantiated, the TAM says that Reg. §1.263(a)-5(f) must be read *in conjunction* with Reg. §1.263(a)-5(e), which provides the bright-line rule for determining deductible nonfacilitative costs and capitalizable facilitative costs.

According to the TAM, the rules in Reg. §1.263(a)-5(f) were not intended to create a more stringent rule concerning the line between facilitative and nonfacilitative costs. Thus, taxpayers who pay success-based fees are also entitled to deduct certain costs incurred before the bright-line date, provided the taxpayer can substantiate those costs.

This is an important piece of technical advice. The TAM appears to say that, apart from the "inherently facilitative" costs, *any* contingent fee incurred before the bright-line cutoff is deductible, provided it is adequately documented. These costs are, by definition, nonfacilitative.

Of course, contingent fees, by their nature, cannot be assessed until after the deal has closed. Thus, it appears that the TAM effectively allows taxpayers to deduct fees that are not quantifiable at the time they are incurred, provided those fees can subsequently be substantiated.

Conclusion

Like so many other areas of the tax law, substantiating deductions is tricky work. It may also be downright tedious. However, for merger costs allocable to contingent-based fees that are incurred before the deal, substantiation appears to be the key.

TAM 201002036 offers two important pieces of technical advice. First, taxpayers must retain detailed records of every expense incurred in the transaction. Second, even if you can't quantify the fees that will be paid to your investment bankers (because they are contingent on the success of the deal), you may still be able to deduct them after the deal is over, provided they were incurred before the bright-line cut off and they can be substantiated.

Readers of CATCHER IN THE RYE may recall Holden Caulfield's admonition to "Don't ever tell anybody anything. If you do, you start missing everybody." More modern and cooperative taxpayers would do better to document every expense, and to be prepared to tell the IRS everything. If they do, they may be able to avoid the loss of their deductions in their M&A deals.