Hither and Yon: Allocating Merger Transaction Costs

By Robert W. Wood • Wood & Porter • San Francisco

Fees for financial advice, legal fees, fees for due-diligence services and expenses incident to arranging debt financing can be hundreds of thousands or even millions of dollars. Understandably, clients want to know how to account for them. The recipients of those fees usually have an incentive to cooperate with the payor. That, of course, is where tax deductions come in. But can such fees be deducted?

If one must give a simple answer, it must be no. Businesses are allowed to deduct ordinary and necessary expenses for carrying on a trade or business. Yet taxpayers must capitalize amounts paid to acquire intangibles, or amounts paid to facilitate the acquisition of intangibles. This is so whether the taxpayer is the acquirer in the transaction or is the target company.

Timing Is Key

One enters the quicksand of capitalization only if an amount can be said to facilitate a transaction. Timing is important. Thus, an amount generally facilitates a transaction only if it relates to activities performed on or after the earlier of:

- the date on which a letter of intent, exclusivity agreement or similar written communication is executed by the acquirer and the target (or their representatives); or
- the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors (or other appropriate governing officials). [*See* Reg. §1.263(a)-5(e)(1).]

This is meant to be a bright-line rule, covering a vast number of expenses. The question is whether the expense "facilitates" a transaction. The bright-line timing rule is meant to provide guidance that is, well, bright-line. Yet notably, the bright-line rule does not cover so-called inherently facilitative expenses.

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Some expenses, the theory goes, are inherently facilitative of a transaction regardless of their timing. Thus, suppose that you pay to secure an appraisal, formal written evaluation or fairness opinion related to a transaction. Whether that expense is incurred before or after the letter of intent is signed, such an expense has only one purpose: to facilitate the deal.

That makes it "inherently facilitative," and that means it must be capitalized. [*See* Reg. §1.263(a)-5(e)(2).] Other examples of inherently facilitative expenses include amounts paid to structure the transaction, including negotiating the structure of the transaction, and obtaining tax advice on the structure of the transaction. Preparing and reviewing the documents that effectuate the transaction represent another big category.

Pursuing and obtaining regulatory approval of the transaction is another huge area, including preparing and reviewing the regulatory filings. Other inherently facilitative items include obtaining shareholder approval of the transaction and expenses associated with conveying property between the parties to the transaction.

There are detailed rules regarding the supporting documentation necessary to establish the portion of any amount paid that is contingent on the successful closing of a covered transaction that is allocable to activities that do not facilitate the transaction. [*See* Reg. §1.263(a)-5(f).]

Debt Issuance

One of the continually thorny areas of the capitalization-versus-deduct dichotomy relates to debt-issuance costs. The regulations provide rules for allocating the costs of a debt issuance over the term of the debt. Debt issuance costs include those transaction costs that were incurred by an issuer of debt that are required to be capitalized under Reg. §1.263(a)-5.

The issuer of the debt, of course, is the borrower. If the costs are otherwise deductible, they would be deductible by the issuer over the term of the debt, as described in Reg. §1.446-5(b).

Latest Letter Ruling

In LTR 200953014 (Sept. 15, 2009), the IRS ruled on the tax treatment of various costs associated with a merger. The target company was acquired through a merger of merger sub into the target, with the target being the survivor. Existing target shareholders received cash.

The target represented that the transaction was a covered transaction under Reg. §1.263(a)-5(e)(3) and that all of the transaction costs were paid or reimbursed at or before closing. The subject costs included legal fees, fees for financial advice, fees for due-diligence services and various other costs.

The IRS ruled that the costs associated with the transaction-related services arranged for by one or more parties could be taken into account by the target. The target had to demonstrate that the services were either rendered to it or on its behalf. Moreover, the fees associated with the services had to have been paid by it or reimbursed by it.

The IRS took advantage of the bright-line date, ruling that except for inherently facilitative costs, the fees incurred prior to the bright-line date could be immediately deducted. The company had represented that the questioned costs were not inherently facilitative because they were incurred in the process of investigating or otherwise pursuing a covered transaction before the bright-line date and were not inherently facilitative. The company anticipated that the transaction would speed the growth of its business.

As to the costs of financing the transaction, the ruling allocates these capitalized costs to each underlying debt instrument. That meant the capitalized costs were deductible by the target over the term of each of the underlying debt instruments. [*See* Reg. §1.446-5.] These costs included a portion of the fees paid to the financier, financial advisors, legal counsel, accounting service providers and general service providers.

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