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When Facilitative Merger Costs May Be Deductible

Abstracted from: *Documenting Deductible Deal Costs*
By: Christopher Karachale *Wood & Porter, San Francisco CA*
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Asset costs normally capitalized. Taxpayers are normally required to capitalize costs associated with purchasing assets or facilitating such purchases until the asset is placed in service. Tax regulations use the term “facilitative” in conjunction with merger costs to describe those costs that a target or an acquiror incurs for investigating or pursuing the deal. Not all facilitative costs must be capitalized, tax attorney Christopher Karachale explains, because IRS regulations allow the deduction of certain costs even though they may have facilitative aspects. On the other hand, costs that are “inherently facilitative” can never be deducted. These include, for example, costs incurred for obtaining appraisal and fairness opinions; negotiating the deal's structure (such as getting tax advice); drafting or reviewing deal documents (such as the merger or purchase agreement); getting shareholders' approvals (such as proxy solicitations); and conveying property (such as title registration expenses).

Bright line date may determine treatment. IRS regulations allow the target or the acquiror to deduct other facilitative costs in certain cases. If these costs are incurred relative to an activity on or after (the earlier of) the date on which the companies sign a letter of intent or the board approves, the deductions are allowed. For example, the taxpayer may take a deduction for expenses paid to determine the deal's value. It may also deduct contingent costs paid to investment bankers pending a successful merger. This deduction is trickier, the author counsels, since the company must allocate the costs among those that are facilitative and those that are not. This deduction also hinges on timing: the company must complete its documentation before it files its tax return for the transaction year. As the author points out, companies often confuse the two deadlines, but one applies to the timing of the costs and the other to the documentation.

Substantiation and documentation are the keys. The IRS issued guidance in 2009 on deducting facilitative costs. Technical Advice Memo 20100036 uses the example of a merger in which the parties did not have time records or detailed invoices that substantiated the allocation of the facilitative and non-facilitative work provided by the investment banking company. The only documentation supplied by the merger parties was a spreadsheet with a breakdown of the general records of work performed by the investment bankers. The IRS takes a holistic approach to the records required for supporting the deduction. In other words, the agency is willing to view the documentation as a whole, which to the author means that a broad range of records can be useful in proving the allocation between deductible and nondeductible costs. As the author stresses, substantiation and documentation may be tricky and tedious, but they are key to taking the deduction.

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