Transaction Costs Webinar Series

PART THREE: Documentation of Deductions, Whose Expense is it?, and Treatment of Capitalized Costs

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September 10, 2019 | 12:00-1:00 PM (ET) | 9:00-10:00 AM (PT)

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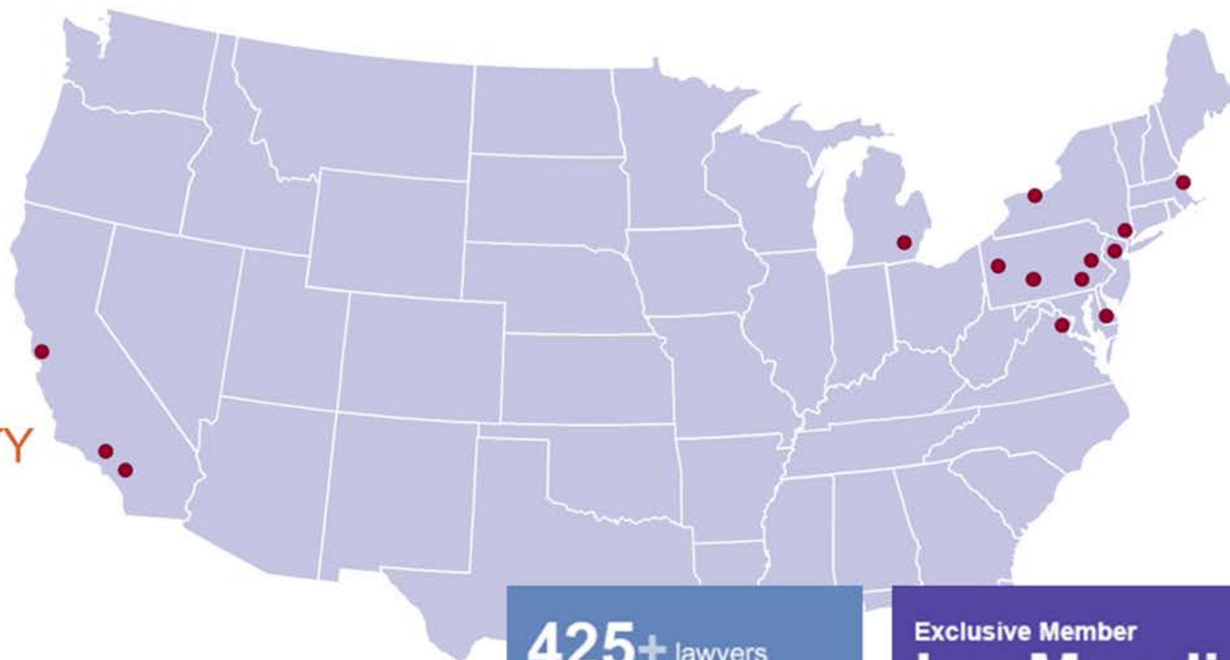

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- Has more than 28 years' experience providing large and mid-size corporate clients advice in corporate tax matters
- Previously worked for the National Tax Group of Moss Adams LLP and Ernst & Young, LLP, where she was a national tax partner and director of M&A tax services for the mid-Atlantic area.

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Q&A

The program will be starting at approx. 12:00pm ET. There is currently no audio until we start.

We are on mute and will be starting in a few minutes.

Email dolanb@pepperlaw.com if interested in receiving a CLE form.

Agenda

- Brief Review of Treatment of Success-Based Fees, and the Safe-Harbor Election, and Discussion on the Documentation of Transaction Fees as Part of Tax Return.
- Default Treatment if No Documentation Assembled with Respect to Transaction Cost Allocations.
- Identify the Factors Present in an Analysis of the "Direct and Proximate Benefit" Test and Which Party Should Take Costs into Account.
- Potential Recovery of Capitalized Transaction Costs.

Review - Safe Harbor Election for Success-Based Fees: Rev. Proc. 2011-29, 2011-1 C.B. 746

- In order to resolve the intense factual document assembly and back and forth with the IRS as to the strength and sufficiency of documentation discussed above, Rev. Proc. 2011-29 provides a safe harbor election (the "Safe Harbor") for allocating success-based fees between activities that facilitate a ***covered transaction*** (i.e., are capitalized) and activities that do not facilitate a ***covered transaction*** (i.e., are not capitalized).
- An election pursuant to the Safe Harbor applies only to the transaction for which the election is made, and once such election is made, it is irrevocable.
  - The election applies to **all** success-based fees paid or incurred by the taxpayer for the transaction for which the election is made.
  - Each party to the transaction must make its own election − it's a taxpayer election, not a transaction election. Thus a separate election must be made for each of the acquiring company and the target company

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Making the Safe Harbor Election

- If the Taxpayer intends to make the election under Rev. Proc. 2011-29, documentation must be assembled and statements must be made indicating that all of the “success-based” fees have been separately designated.
- The election is not valid if any of the success based fees are not included in the election form.
- The Taxpayer must also provide verification that the transaction is a “covered transaction” as defined in Treas. Reg. Section 1.263(a)-5(e)(3).
- The party making the election must be either the target or the acquiring company.
- Individual shareholders cannot make the election.

What if you "miss" the safe-harbor election?

- Reg. § 301.9100-3 – Ruling Request
- Private letter ruling request
- As of February 2, 2019, user fee is $10,900
- To obtain relief, a taxpayer must show—
- It acted reasonably and in good faith;
- Requests relief prior to discovery by IRS of taxpayer's failure to make the regulatory election;
- Failure to make the election due to events beyond the taxpayer's control;
- Was unaware of the election (assuming taxpayer exercised reasonable diligence);

9100 Relief for missed elections

- Reasonably relied on written advice from IRS; or
- Reasonably relied on qualified professional and professional failed to make or advise taxpayer to make the election
- Granting relief would not prejudice the interest of the government
- Taxpayer's aggregate tax liability would be lower for all years to which election applies than if election had been made timely (taking into account time value of money)
- Several recent IRS Rulings allowing additional time to file the safe harbor election—
  - For example, *see, PLR 201935001 (60 Days), PLR 201804002 (45 Days), PLR 201711003 (60 Days), PLR 201648002 (60 Days), PLR 201606003 (60 Days).*

Simple Example -After review of all invoices, and other documents, including a review of any success-based fees (Elected Safe Harbor) you can allocate the costs over the various categories--

Service Provider	Party that		Ordinary Business	Employee Costs	Investigatory Pre-Bright Line	Facilitative and Post-Bright Line Investigatory	Financing	Total
	Hired	Paid						
Investment Advisor 1	A	T			$1,400,000*	$600,000*		$2,000,000
Investment Advisor 2	T	T			$350,000*	$150,000*		$500,000
Consultant	A	T		$200,000				$200,000
Law Firm 1	T	T	$50,000	$35,000	$250,000	$150,000	$45,000	$530,000
Law Firm 2	A	T		$40,000	$100,000	$750,000	$75,000	$965,000
Accounting Firm 1	A	T		$15,000	$150,000	$45,000	$10,000	$220,000
Accounting Firm 2	T	T	$35,000	$10,000	$210,000	$35,000	$5,000	$295,000
Bank	A	T					$750,000	$750,000
Totals			$85,000	$300,000	$2,460,000	$1,730,000	$885,000	$5,460,000

Allocation of Costs Between Transaction Participants

- Generally, one corporation's payment of another corporation's expense does not give rise to a trade or business deduction for the payor corporation.
  - *Interstate Transit Lines v. Comm'r*, 319 U.S. 590 (1943)
    - A corporation could not take a deduction for the operating deficit that it reimbursed to its subsidiary. Id. at 594.
- Such payments of another's obligations are not deductible as ordinary or necessary business expenses because they are not "ordinarily" incurred in the payor's trade or business.
  - *South Am. Gold & Platinum Co. v. Comm'r*, 8 T.C. 1297 (1947)
    - A parent holding company could not deduct legal expenses, incurred from negotiating and carrying out a settlement agreement on behalf of its subsidiaries where the subsidiaries acquired additional proprietary rights, as ordinary and necessary business expenses because these expenses were (1) not incurred in carrying out the parent company's business and (2) were made to hold or acquire capital assets. *Id.* at 1302.

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Exception: The "Direct and Proximate Benefit" Test

- Courts apply the "direct and proximate benefit" test in determining whether one company's payment or reimbursement of another company's expense is deductible or properly taken into account by the paying or reimbursing company.
- To satisfy the threshold requirements of this test, the taxpayer must prove that the specific services or activities giving rise to the claimed deduction were performed for the taxpayer's direct and proximate benefit.

Information Supporting Application of the Direct and Proximate Benefit Test

- A deduction may be available when
  - an expense directly relates to the taxpayer's business, and
  - the taxpayer pays or reimburses such expense.
- Facts and circumstances determination
- Requires extensive documentation, including, but not limited to:
  - Engagement letters for original work
  - Factual narrative describing the benefit of the services to the paying taxpayer
  - Factual discussion on how such services relate to the paying taxpayer's business and are not related to the investment aspects of the transaction
  - Transaction documents indicating who paid the fees and when such payments were made.

Priv. Ltr. Rul. 200830009 (July 25, 2008)

- Parent, Company ("Taxpayer"), Investor Group and Acquisition Co. were involved in a merger transaction through which Taxpayer was acquired by merging with Acquisition Co., with Taxpayer surviving.
- Fees related to this merger transaction included:
  - Parent arranged transaction services that were directly provided to and coordinated with Taxpayer.
  - Acquisition Co. incurred transaction costs including fees for financial advice, legal services, and due diligence services.
  - Taxpayer paid fees to secure debt financing; providers of such financial services were not engaged directly by Taxpayer.
  - Investor Group arranged underwriting services on behalf of Taxpayer as part of obtaining the debt financing and engaged other service providers on behalf Acquisition Co., the services of which directly benefitted Acquisition Co.

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Priv. Ltr. Rul. 200830009

- Taxpayer requested permission to allocate the transaction costs based on which entities directly and proximately benefited from the services and paid or reimbursed the fees associated with these services.
- The IRS concluded that Taxpayer could allocate transaction costs based upon the entity to which the services were rendered and/or on whose behalf the services were provided, despite the fact that the payor of such costs may not have been the original obligor.
  - Priv. Ltr. Rul. 200953014 (Sept. 15, 2009)
    - In facts similar to above, the IRS concluded that certain transaction costs arranged by one party to the transaction could be allocated to another party when the services were rendered for or on behalf of such other party.

Specialty Restaurants v. Commissioner, 63 T.C.M. (CCH) 2759

- Specialty ("Taxpayer") opened restaurants by forming wholly owned subsidiaries, incurring costs, and having the new subsidiary acquire the restaurant. Taxpayer deducted expenses incurred in connection with the creation of each subsidiary and acquisition of each restaurant as ordinary and necessary business expenses under Section 162.
  - Included in these expenses were rent, interest, salaries and wages, travel to and from the site and training employee costs.
- Commissioner disallowed these deductions and held the expenses to be preopening expenses capitalized under Section 263 or amortized under Section 195.
  - Also, Commissioner categorized them as the respective subsidiaries' expenses, not expenses of the Taxpayer.

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Specialty Restaurants v. Commissioner

- Taxpayer argued that expenses incurred in the creation of each subsidiary were an expansion of its existing business, and thus were its expenses.
  - Section 162(a) generally allows a current deduction for ordinary and necessary business expenses paid or incurred in a taxable year in association with taxpayer's trade or business.
- Commissioner maintained that the subsidiaries and Taxpayer were separate entities and must be taxed as such.

Specialty Restaurants v. Commissioner

- The Court held:
  - Section 195 did not apply because Taxpayer did not elect to amortize such expenses.
  - The expenses, to the extent actual business operations commenced when such expenses were paid or incurred, would be properly deductible by the subsidiaries, not Taxpayer. However, the Tax Court held that the expenses paid by the Taxpayer were capital contributions from Taxpayer to the subsidiaries.
  - Further, the Tax Court held that the subsidiaries could not deduct these expenses because the trade or business requirement of Section 162 does not allow deductions for preopening expenses until a trade or business has begun to function and has performed activities for which it was organized.
    - Thus, the expenses were not properly deductible by the subsidiaries under Section 162 because actual business operations had not commenced in the years that the deductions were claimed.

Square D Co. v. Commissioner, 121 T.C. 168 (2003)

- Taxpayer was the target of a hostile takeover by Acquiring Corporation (“Acquiring”).
- Acquiring specifically created a transitory subsidiary corporation (“ACQ”) to facilitate the acquisition of Taxpayer, and agreed to pay loan commitment and legal fees on behalf of ACQ.
- In pursuing the acquisition, Acquiring (on behalf of ACQ) incurred legal fees and arranged a loan to fund the takeover and to provide operating capital thereafter.
- After hostile negotiations, ACQ merged into Taxpayer, with Taxpayer surviving.

Square D Co. v. Commissioner, cont.

- The Tax Court determined that Taxpayer received a direct benefit from the legal services, despite not being a party to the contract pursuant to which these services were provided, because these services were performed for the benefit of Taxpayer.
- The Tax Court concluded that when acquisition costs are incurred on behalf of the subsidiary which merged with Taxpayer (and thus, are incurred on behalf of Taxpayer) and then paid by Taxpayer, Taxpayer may appropriately deduct the associated costs paid.
- In other words, "a corporation may in certain circumstances deduct expenditures incurred on its behalf by a shareholder, where it makes a reimbursement." *Square D.* at 198.

Paying Expenses of Another – Summary

- IRS rulings and the *Square D* court recognize the concept of one taxpayer's ability to deduct costs originally incurred by another taxpayer, if the paying taxpayer can demonstrate how those costs benefit the paying taxpayer.
- In order to deduct costs under Section 162 they must be "ordinary and necessary" to the deducting taxpayer.
- Important to recognize the distinction between a Section 162 cost (business expansion) and a Section 195 cost (cost associated with a business start-up)
  - Both can include preliminary investigatory costs described in Treas. Reg. §1.263(a)-5(e)(1), i.e., certain costs incurred prior to the "bright line" date.

What to Include in the Tax Files for the Year that the Transaction Costs are Taken into Account

- Electronic Files that include internal accounting for the Transaction Costs.
- Deal Documents, including, any
  - Letter of Intent and/or Exclusivity Agreement, and/or a Confidentiality Agreement.
  - Execution copy of the Flow of Funds Memorandum, with wire transfers showing the date of payment of the invoices and the party designated as payor and payee.
    - Documentation of the payor is critical to the cases where the parties are attempting to "push" costs to another party.
  - Detailed calculations, if any, showing additions and subtractions to the working capital account, and descriptions of payments to specific service providers made by the taxpayer on or after closing.

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What to Include in the Tax Files for the Year that the Transaction Costs are Taken into Account

- Deal Documents
  - Execution copies of any Acquisition Agreement, including schedules and any side-agreements.
  - Debt Instruments created or modified as part of the transaction, including schedule of the financing costs.
  - Insurance Policies where the costs of such policies are treated as transaction costs.
- Documents gathered as part of the review of service provider fees and services, including:
  - Engagement letters and Invoices from the identified service providers including accountants, lawyers, employment experts, bankers, IT firms
    - This information should include: name and contact information for a point person at each firm that is able to discuss the scope of services.
  - Fee allocations provided by service providers whose invoices were not sufficiently detailed to document an allocation of their fees.

What to Include in the Tax Files for the Year that the Transaction Costs are Taken into Account

- Documents gathered as part of the review of service provider fees and services.
  - Any reports and structuring documents or step plans generated by due diligence or transaction planning teams as part of the investigatory activities of either the acquiring company or the target.
  - Research documentation from public sources (i.e., websites, etc. that describe the relevant services for certain of the service providers)
  - Interview notes from the relevant service providers verifying the work that was done, and the timing of such work, if relied upon in the allocation process.
- Emails and other correspondence documenting facts relevant to the allocation process, including whether a particular fee is a “success-based” fee.

What to Include in the Tax Files for the Year that the Transaction Costs are Taken into Account

- Internal Corporate Documents of Taxpayer, including, if reviewed,
  - Board of Director meeting minutes of Taxpayer (including any presentations by outside service providers) reflecting key decisions and the dates of such decisions with respect to the transaction and/or services provided with respect to the transaction.
  - Statements from key management at either the acquiring company or target or both to verify and explain what the service providers were doing and when they were doing it (if such information is not clear from the invoices or other documents). Documents indicating that certain fees paid by Taxpayer were success based fees.
  - Any financial statements of Taxpayer for the relevant time period covering the transaction.
  - Phone records or other time verification information relevant to the substance and/or timing of discussions or key decision dates.

What to Include in the Tax Files for the Year that the Transaction Costs are Taken into Account

- Transaction Cost Allocation Report
  - This typically includes an "Allocation Spreadsheet" showing each service provider, the total amount of fees, the amount allocated to each type of category of services, investigatory fees incurred prior to the bright-line date, if applicable, etc.
  - "Technical Discussion" document (may be a tax opinion if the taxpayer engages an outside advisor to perform) that summarizes key facts relating to the allocation process and tax authority relied upon for certain technical positions taken with respect to certain fees, including whether certain costs can be taken into account by a party other then the party that engaged a service provider.
  - The "Documents" listed above that support the facts relied upon to make the allocations, including the deal structure (to determine if it is a "covered transaction"), engagement letters (may indicate if success-based, or timing of services), fee allocation letters, detailed invoices, reports generated by service providers, etc.
  - The "Safe Harbor Election" of Rev. Proc. 2011-29 if applicable.

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Can Capitalized Costs be Recovered? - Cost Recovery Provisions

- ***Section 1060*** (costs identified with the acquisition of a particular asset can be added to the cost basis of such asset and recovered over its useful life)
- ***Section 338*** (stock purchase treated as an asset purchase that allows acquisition costs to be allocated to the assets purchased and recovered over the life of the assets acquired, or reduce the gain if such assets are sold)
- ***Section 197*** (costs associated with acquiring certain 197 intangibles can be added to the cost basis of such assets and amortized over the life of the asset – typically 15 years)
- ***Section 248*** (certain organizational costs can be amortized over 15 years)
- ***Section 195*** (preliminary, investigative costs and other start –up costs can be amortized over 15 years)
- ***Section 165*** (allows recovery for costs that are incurred for a transaction that is "abandoned")
  - This provision typically requires significant documentation and analysis of when a transaction, an entity, or an asset is "abandoned"

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Can Capitalized Transaction Costs be Recovered? – Section 263 Capitalized Costs

- We infer from the INDOPCO and other cases that capitalized transaction costs somehow go on the "books of the company" when the transaction closes.
- Once a liquidation or other sale event occurs, an analysis of whether or not the previously capitalized costs can be deducted needs to be reviewed and documented.
- Treas. Reg. § 1.263(a)-5(g) – provides authority for limited instances of how to treat certain capitalized costs:
  - Capitalizable Costs paid by target company in an asset sale are treated as an offset to purchase price, and generally reduce any gain realized by the target comopany upon such sales.
  - Capitalizable Costs paid by the acquiring company in the acquisition of stock of the target company or assets of the target company are added to the tax basis of such stock or assets, as the case may be, and thus may decrease any gain on the sale of the target stock, or target assets, or allow for additional depreciation for the acquired assets.

Vulcan Materials Co. v. U.S., 446 F.2d 690 (5th Cir. 1971).

- In 1954 two corporations were merged into a third corporation, in Section 368(a)(1)(A) reorganizations. When the resulting corporation merged again in 1957, it deducted the costs associated with the 1954 mergers.
- Even though an "A" merger mechanically requires the Target company to cease to exist, the Target company is succeeded to by the Acquiring company for federal income tax purposes and its business enterprise has not ceased.
- Held - capitalized costs associated with a prior merger are not recognized as liquidation costs upon a subsequent merger, but carry over and are associated with the ongoing business.
  - This is the case in a Section 332 liquidation even if it is not a statutory merger under Section 368(a)(1)(A).

McCrory v. United States, 651 F.2d 828 (2d Cir. 1981)

- In *McCrory v. U.S.*, Taxpayer acquired two Target corporations by statutory merger. The activities of each Target corporation proved unprofitable, and after three to four years, taxpayer sold all of the assets of each Target corporation and liquidated the Target corporations pursuant to Section 332.
- Taxpayer deducted the previously capitalized merger costs on its tax returns for the years in which the Target corporations were liquidated.
- The court concluded that Taxpayer had a dual purpose for acquiring the Target corporations:
  - Raising capital (these costs were non-capitalizable and non-recoverable); and
  - Purchasing the Target corporations (these costs were capitalizable when incurred).

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McCrory v. United States

- In allowing a partial recovery of the previously incurred costs, the court concluded that,
  - Costs associated with raising capital were non-deductible capital expenditures and could not be recovered when the businesses were sold and the Target corporations were liquidated.
  - Costs associated with the acquisition of the two Target corporations that were previously capitalized as transaction costs, could be recovered when the businesses were sold and the Target corporations were liquidated.
- The court also acknowledged that significant recordkeeping would necessarily be required to document the amount of the previously incurred costs that were treated as capitalized transaction costs at the time of the acquisition of the Target corporations.

Recent Authority Addressing Cost Recovery for Section 263 Capitalized Costs

- LB&I Transaction Unit – (04/30/19) Book 225, Chapter 4 – Treatment of Costs in a Corporate Separation
  - In general, costs incurred to separate two businesses are not deductible, but must be capitalized, unless the separation is required by law, regulatory mandate, or court order, or the separation transaction is abandoned.
- An exception for costs previously capitalized in a reorganization by the distributing company can be supported when the previously acquired business is discontinued through the Section 355 distribution process. The IRS describes the documentation process required to treat the property acquired in an acquisition transaction and then distributed in a Section 355 transaction as abandoned for purposes of Section 165. (citing *McCrory*)
  - Requires that the distributing corporation "abandoned the controlled corporation's stock" in the distribution.
  - Requires that the separation caused an "bonafide, uncompensated loss evidenced by closed and completed transactions, and fixed by identifiable events, as required under Treas. Reg. 1.165-1(b)…"

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Recent Authority Addressing Cost Recovery for Section 263 Capitalized Costs

- An exception may also exist for a controlled corporation to deduct certain previously capitalized costs:
  - While the controlled company cannot deduct costs associated with the separation itself (Section 355 transaction), it may be able to support an argument that the prior capitalized costs associated with a Target corporation (previously acquired by the distributing corporation in a stock purchase) whose assets or business controlled now holds, may result in a potential Section 165 abandonment deduction for those previously capitalized costs.
    - Requires that the prior Target corporation, dissolved in the separation transaction (presumably the Target corporation was liquidated into the controlled entity or otherwise acquired prior Target's assets– but this is not clear);
    - Requires that any "synergistic and resource benefits associated with the controlled corporation's affiliation with the distributing corporation terminated in the corporate separation"; and
    - Requires that the separation of the controlled corporation's affiliation with the distributing corporation caused an "bonafide, uncompensated loss evidenced by closed and completed transactions, and fixed by identifiable events, as required under Treas. Reg. 1.165-1(b)…"

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Best Practices – Supporting the Recovery of Capitalized Costs

- For every transaction, document the costs incurred to preserve the information that relates to the existence of capitalized costs.
- Determine if the capitalizable transaction costs are added to stock basis, or to the tax basis of a particular asset or group of assets, or are "associated with the business enterprise" (the *Indopco* position).
- If a target or an acquiring corporation has these types of capitalized transaction costs, make sure to "carry over" this information if such corporation is merged into another group member, either through liquidation or statutory merger.
  - Practice Tip: It may be beneficial to prepare a tax basis balance sheet showing these potential categories of capitalized costs. While there is no amortization, it may assist with documenting their existence.
- If the business of the target corporation is abandoned or part of other discontinued operations, make sure to review potential abandonment positions that may be taken.
  - Note that taking an abandonment position will require detailed analysis of the event and timing of such abandonment, and may require an actual liquidation of the entity.

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Example of Transaction Cost Allocations – Documentation of Capitalized Costs—Relevant category "Facilitative and Post-Bright Line Investigatory"

Service Provider	Party that		Ordinary Business	Employee Costs	Investigatory Pre-Bright Line	Facilitative and Post-Bright Line Investigatory	Financing	Total
	Hired	Paid						
Investment Advisor 1	A	T			$1,400,000	$600,000		$2,000,000
Investment Advisor 2	T	T			$350,000	$150,000		$500,000
Consultant	A	T		$200,000				$200,000
Law Firm 1	T	T	$50,000	$35,000	$250,000	$150,000	$45,000	$530,000
Law Firm 2	A	T		$40,000	$100,000	$750,000	$75,000	$965,000
Accounting Firm 1	A	T		$15,000	$150,000	$45,000	$10,000	$220,000
Accounting Firm 2	T	T	$35,000	$10,000	$210,000	$35,000	$5,000	$295,000
Bank	A	T					$750,000	$750,000
Totals			$85,000	$300,000	$2,460,000	$1,730,000	$885,000	$5,460,000

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Q&A

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