M&A Tax Talk

Transaction costs: Tax recovery and treatment

As there is an increased focus on M&A preparation and strategy,[1] one area that should not be overlooked, or assumed to have an immaterial impact, is the potential tax “recovery” of transaction costs. In a typical deal, both buyers and target companies will incur significant fees for third party service providers such as financial advisors, legal advisors, accountants, and consultants. Whether these costs can be recovered for tax purposes and by whom is dependent upon a number of factors, including the structure of the transaction, by whom the services have been engaged, and the nature of the services provided. In addition, provisions in the transaction agreement referencing transaction cost treatment may require advance planning. Therefore, it is important for taxpayers not to oversimplify the approach or delay analyzing these costs as it could lead to inaccuracies in the treatment of the costs.

General

The general rule on the U.S. federal income tax treatment of transaction costs, Treas. Reg. § 1.263(a)-5, requires capitalization of costs incurred in connection with a capital transaction, which is how most M&A transactions would be categorized.[2] This general baseline treatment could lead a taxpayer to simply defer the analysis given the expectation would be non-recovery of these costs (i.e., not deductible or amortizable). However, there are certain exceptions within the rules that can be applied which do not require capitalization. Certain costs such as integration and employee compensation are specifically excluded from the capitalization requirements and other costs are specifically addressed in the regulations with special rules which require transaction-based analysis and documentation. An important factor in determining whether any special rules or exceptions to the general rule would apply depends upon how the transaction is structured.

Transaction structure

Not all costs necessarily need to be capitalized in a capital transaction, with specific, advantageous rules available for transactions that qualify as “covered.” Covered transactions generally include taxable stock or interest acquisitions of greater than 50 percent of ownership (but only by the acquirer or the target, not the seller), taxable acquisition by the taxpayer of assets that constitute a trade or business, and a number of section 368 reorganizations.

If a transaction qualifies as covered, a taxpayer may benefit in two ways. The first being that taxpayers may recover costs incurred prior to the “brightline” date that are not inherently facilitative (e.g., due diligence). The investigatory costs incurred prior to the brightline date are referred to as “non-facilitative.” This brightline date is the earlier of: (i) the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is signed by representatives of the acquirer and target; and (ii) the date on which material terms of the transaction are authorized or approved by the taxpayer’s board of directors, or in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction are authorized or approved by appropriate governing officials.

[1] See Deloitte “2024 M&A Trends Survey; Mind the Gap.” Link to the full report can be accessed at www.deloitte.com/us/mergers.
[2] References to “Treas. Reg. §” refer to the U.S. Department of the Treasury regulations issued under the Internal Revenue Code of 1986, as amended.

The second benefit of qualifying as a covered transaction is the taxpayer's option to elect safe harbor treatment for success-based fees under Rev. Proc. 2011-29. Filing this safe harbor election statement on the taxpayer's timely filed return will allow the taxpayer to recover 70% of these qualifying success-based fees, which are typically the most significant costs incurred during a transaction.

However, as described above, the transaction needs to qualify as covered to obtain these two exceptions, and when dealing with a complex transaction structure, this is not always straightforward and may require time to analyze and document. Therefore, given the importance of this covered transaction qualification, taxpayers with a complex transaction structure should assess this qualification early, as it impacts the overall approach taken for these studies.

Entity recognition

It is not unusual for certain transaction costs to be paid by other legal entities that are not directly receiving the benefit of those costs. Given the opportunity for confusion in this area, it is important for support to exist related to the entity that is receiving the proximate and direct economic benefit of the services, and in turn, is the entity recognizing the cost for tax purposes. Supporting this, however, can be an art rather than a science as the Internal Revenue Service, in a directive to their field agents on July 2, 2018, listed various factors that should be considered. Examples include what services were provided, to whom the services were provided, and to whom the service provider reported. Given this concept is transaction specific, it is important to understand the nature of the services provided as well as the cash flow between entities in the process of paying for these costs. Waiting to assess this at the last minute could lead to inaccuracies of recognition, especially since there could be deemed contribution and distribution issues between legal entities depending on the reimbursement or intercompany arrangements.

Amortization versus current deductibility

Section 162 requires that deductible business expenses be directly connected with or pertaining to the taxpayer's trade or business.[3] However, what happens to buyer-side costs that are incurred in a newly formed corporate entity that does not have a trade or business prior to closing the transaction? This is a nuance to be assessed based on transaction structure and the filing profile of the taxpayer. When the entity making the direct acquisition of a target is a holding company that does not have its own business operations, the buyer's non-facilitative costs are potentially viewed as related to entering a new line of business and may therefore be amortized as start-up costs under section 195 over a 180-month period. In addition, even if the acquiring entity is an existing entity with an ongoing business, the same issue may be presented as to whether the transaction, and related costs incurred, are for expanding an existing business or entering a new line of business. The former would be deductible under section 162 whereas the latter may also have to be amortized under section 195. Therefore, this is another important aspect to consider as current versus long term recovery could result in a last-minute surprise to current year taxable income.

To illustrate this point, consider that a private equity enterprise may incur costs in connection with investigating a target company and subsequently creating a new holding company to acquire the target. In this example, the costs incurred by the private equity would be viewed as incurred for the benefit of the newly created holding company as the buyer in the transaction. Because the newly created holding company does not have an active business until the time of the transaction close, the recoverable transaction costs incurred prior to closing, usually including a portion of the success-based fees, are viewed as costs incurred in connection with entering a new line of business and are therefore amortized over 180-months as start-up costs under section 195.

Treatment of capitalized costs

The transaction cost regulations (Treas. Reg. § 1.263(a)-5) are reserved on the treatment of certain capitalized costs. This can lead to confusion of what to do with the costs identified as facilitative and requiring capitalization. Although there are exceptions that allow recovery of these costs, a good portion of the transaction cost pool usually requires capitalization because most costs incurred are considered "inherently facilitative" which require capitalization regardless of when incurred during the transaction life cycle (e.g., structuring, documents, regulatory, etc.).

The potential for future recovery of these capitalized costs comes back to the structure of the transaction. For example, a buyer incurring costs in a taxable stock acquisition would capitalize these costs to the basis of the acquired interests resulting in a potential reduction in the gain on a future sale. However, a target company acquired in the same taxable stock acquisition with capital costs has not acquired anything to which it can capitalize these costs. Although this is one of the items that Treas. Reg. § 1.263(a)-5 has specifically reserved, the general approach is that the target's capitalized costs are treated as an unamortizable intangible. Given these differences in future potential recovery, it is important to appropriately determine both the amount and method of capitalization.

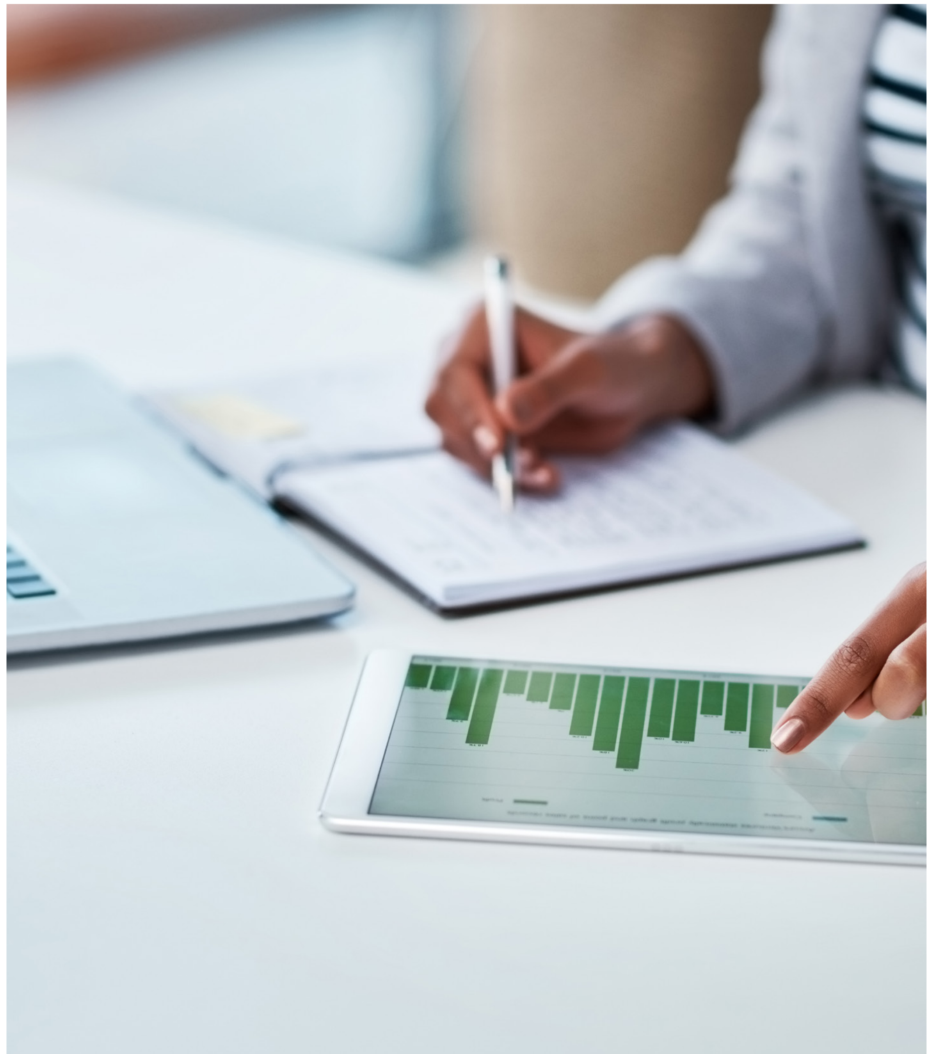
[3] All section references are made to the Internal Revenue Code of 1986, as amended.

Cost tracking

Based on the types of service providers that are involved in transactions, notably accounting and law firms, a taxpayer runs the risk that costs related to the transaction could be misidentified or intermingled with normal course business expenses when being recorded to the books. Inaccuracies in reporting and not organizing transaction specific costs could lead to not only extra work in identifying the accurate pool of costs for filing time, but potentially lead to inappropriately deducting a cost that requires capitalization. If possible, taxpayers should focus on having a recording approach to easily identify these costs as well as the underlying detail which is needed to properly analyze for tax recovery. Failure to do so (or having an inefficient recording process) could lead to difficulties in the analysis, especially if that analysis is not started with appropriate time to assess prior to the filing date.

Conclusion

Given the many nuances and transaction specific considerations related to the recovery of transaction costs, taxpayers should consult with their tax advisor to address these issues and perform a transaction cost analysis. Taxpayers should not oversimplify the approach to analyzing the recoverability of these costs and should be proactive in evaluating their treatment before permitting the deal process to advance too far. In addition, taxpayers should allow enough time to properly document certain positions such as covered transactions and reason for recovery, especially if those costs are significant to the return and multiple entities are impacted with respect to cost recognition.



Want to learn more? Reach out to our contacts below.

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