Transaction Costs in Acquisitions

By Robert W. Wood • Robert W. Wood, P.C. • San Francisco

M&A TAX REPORT readers know better than anyone that one of the most painful post-acquisition cleanup items relates to transaction costs. Taxpayers have an obvious incentive to deduct. The government has an obvious incentive to require capitalization. It's nearly as classic a dichotomy as oil and water, church and state or drinking and driving. You get the idea. Over the years, these pages have featured quite a lot of *INDOPCO*-bashing (on that note, *see* Stuart Vogt, *The Costs of Failure: Learning from Your Mistakes*, M&A TAX REPORT, July 2005, at 1).

There has been a tendency on the part of the IRS to focus on capitalizing just about everything. This has left taxpayers in a bit of a quandary. I don't know how much it will help, but it is noteworthy that the IRS National Office recently issued a memorandum for field specialists relating to the examination of transaction costs in acquisitions. [2005 TNT 100-19.] This comes from the Large and Mid-Size Business Division (LMSB), announcing a directive to examining agents with a benchmarking tool (that's what they call it, anyhow) to assist agents in determining whether to audit the tax treatment of transaction costs in connection with acquisitions or dispositions of a trade or business.

The directive applies only to the treatment of transaction costs, and only to those incurred in a merger or acquisition, as defined in Reg. §1.263(a)-5(e)(3). That means the directive does not apply to costs in stock issuances, stock distributions or other divisive deals, stock redemptions or reacquisitions, payments of dividends and other corporate distributions, *etc.* Plus, the new directive expressly does not apply to the treatment of termination fees incurred by a taxpayer in an M&A deal.

Quite appropriately, the directive notes that any determination whether to capitalize or deduct is highly fact-intensive, and that makes the investigatory process for an auditor extremely time consuming. The theory of Reg. §1.263(a)-5(e) was to draw bright lines, clarifying the treatment of costs incurred within the ambit of a business acquisition. The regulations therefore seek to separate investigative costs from those that actually facilitate the acquisition. The regulations include record keeping requirements too.

The directive indicates that LMSB examinations generally result in the capitalization of 50 percent to 65 percent of the applicable transaction costs incurred up to the time of the consummation of the acquisition. That's an interesting statistic.

The main point of the directive seems to be that auditors should consider whether the taxpayer's return position falls within the examination results that the IRS notes. This, presumably, is the "benchmarking" that's the point of the directive. I guess if the auditor comes up with less than the 50 to 60 percent in the capital category, they should do some more homework.

In fact, the directive states that, "[W]e caution auditors that where they have already expended significant resources in audit of this issue and the apparent results differ significantly from the 50 percent to 65 percent benchmark range, the auditor should pursue his/her determination based on the facts and circumstances of the audit." Hmm ...

Today, Special Limited Time Only!

The compliance measure instituted by this directive is limited in time. It does not apply to any M&A transaction cost item paid or incurred on or after December 31, 2003. It also does not apply to amounts paid or incurred in tax years ending on or after January 24, 2002, for purposes of computing the Code Sec. 481 adjustment, where the taxpayer has changed its accounting method to comply with Reg. §1.263(a)-5(e) of the regulations.