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IRS Lets Investment Advisor Deduct $275 Million "Support Payment" to Target Shareholders

By Donald P. Board • Wood LLP

There is nothing exotic about M&A transactions in which the parent of the acquiring corporation provides the consideration delivered to the target's shareholders. Indeed, a fair patch of Subchapter C is devoted to "triangular" reorganizations, in which the acquirer pays with shares of its parent's stock. The rules are technical and sometimes arbitrary, but the transactions themselves are familiar enough.

It is not every day, however, that we see an acquisition in which an *unrelated* business entity kicks in some of the sale price. Yet such transactions do occur, and the third-party dollars can be quite substantial. Not surprisingly, they can also raise tax issues.

The $3.4 billion acquisition of American Capital, Ltd. by Ares Capital Corporation (Ares Capital) provides a case in point. As part of the deal, the investment advisory firm that *manages* Ares Capital paid the target's shareholders $275 million to approve the transaction. In LTR 201736002 (June 8, 2017), the IRS ruled that the investment advisor could deduct the whole amount in the year it was paid.

When Ares Met Ares

Ares Capital is a NASDAQ-traded finance company. With about $14 billion in assets, Ares Capital is the largest "business development company" registered under the Investment Company Act of 1940.

Ares Capital may be number one, but it does not go it alone. A separate investment advisory firm, Ares Capital Management LLC (Ares Management), manages Ares Capital. For a fee, of course.

This no doubt sounds like a family affair. But Ares Management is owned by Ares Management, L.P. (Ares LP), which is an independent, NYSE-traded company. Despite their overlapping names and some shared history, Ares Capital and Ares Management are *unrelated* for both tax and securities law purposes.

Acquiring American Capital

On January 3, 2017, Ares Capital completed a reverse triangular merger in which it acquired 100 percent of the shares of American Capital, Ltd. (ACL), a publicly traded private equity firm and asset manager. In the merger, ACL's shareholders received total consideration worth $3.4 billion—*i.e.*, $18.06 per share.

We can trace the $18.06 to three sources. The first was the acquirer, Ares Capital, which contributed $6.48 in cash and its own stock worth $7.93. Second was the target, ACL, which sold one of its business units to a third party for cash. The sale generated an additional $2.45 for distribution to ACL's shareholders.

That accounted for $16.86 per share. The remaining $1.20 was paid by *Ares Management*, which, as noted, was unrelated to Ares Capital and ACL. Ares Management did not receive anything in the merger, but it still delivered $275 million at closing as a "support payment" for ACL's shareholders.

How to Report the Support?

So far, nobody has sued the Ares Management's directors for waste, which suggests that the support payment served a legitimate business purpose. Okay, then what about tax? If the $275 million transfer was not simply a manifestation of detached and disinterested generosity, how should Ares Management report the payment on its 2017 federal income tax return?

Initially, Ares Management wasn't sure. In its annual report on Form 10-K (Feb. 24, 2017), Ares LP told investors that the proper tax treatment of the payment was "unclear and subject to final determination." The company suggested that the tax outcome "could range from an immediate tax deduction of $275.0 million in 2017 [to] amortizing the amount over a prescribed life, typically 15 years."

In the usual Form 10-K, one would expect this to be followed by the lofty observation that any adverse tax consequences would be just one drop lost from a large bucket. But Ares LP laid it on the line. The company warned investors that an unfavorable tax determination would "materially affect our net taxable income and the amount of distributions to our common unitholders." Gulp.

But the story had a happy ending. Behind the scenes, Ares Management had applied for a private letter ruling. On August 12, during an earnings call, the company announced that the IRS had approved an *immediate deduction* for the $275 million payment. That's as good as it gets.

LTR 201736002, I Presume?

The IRS's only recent ruling in this area is LTR 201736002 (June 8, 2017). The unidentified taxpayer dated its ruling request January 3, 2017, which just happens to be the day that Ares Capital completed its acquisition of ACL. Hence, it seems safe to assume that LTR 201736002 was the ruling that allowed Ares Management to deduct the shareholder support payment.

In the discussion that follows, it will be helpful to adopt a version of the IRS's generic terminology. In the underlying transaction, *Acquirer* (Ares Capital) acquired all of the stock of Target (American Capital). *Advisor* (Ares

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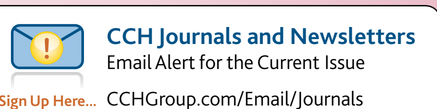
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Management) and *Parent* (Ares LP) requested a ruling on the tax treatment of Advisor's payment to Target's shareholders.

Facts About Fees

The basic facts of LTR 201736002 were as described above. But the letter ruling provides important details concerning the fees that Advisor charged Acquirer for its services. The ruling also includes significant information regarding the terms governing termination of the arrangement.

The letter ruling states that Advisor was managing Acquirer pursuant to an investment management agreement (IMA). Under the IMA, Acquirer was required to pay Advisor a management fee with three components:

- A percentage of Acquirer's total assets;
- A percentage of Acquirer's net investment income; and
- A percentage of Acquirer's cumulative net realized capital gains *minus* its unrealized capital depreciation.

Advisor plainly stood to benefit from any transaction that would bring more assets and income into Acquirer. Consequently, Advisor was motivated to do more than just root for the acquisition to close. Advisor represented to the IRS that it had agreed to make the support payments because it expected the merger to "result in earning higher fees from Acquirer under the IMA."

Deduction Under Code Sec. 162

The first question, as usual, was whether Advisor's $275 million payment was an "ordinary and necessary" expense incurred in connection with Advisor's trade or business. [*See* Code Sec. 162(a).] The IRS saw no reason to doubt that the support payment was "necessary" in the Pickwickian sense of being "appropriate or helpful" to the development of the taxpayer's business. [*See W.F. Tellier*, SCt, 66-1 USTC ¶9319, 383 US 687, 689, 86 SCt 1118 (quoting *Welch v. Helvering*, SCt, 3 USTC ¶1164, 290 US 111, 113, 54 SCt 8).]

"Ordinary" did not pose much of a hurdle, either. Advisor had represented to the IRS that, in the investment advisory business, it is *common* for advisors to provide various financial incentives to third parties. The goal is to help the entities they advise attract and retain investors.

Although heartfelt, the teenager's plea that "everybody's doing it" usually falls on deaf ears. But it made perfect sense to the IRS. Under the "normal, usual, or customary" standard of the *DuPont* case [SCt, 40-1 USTC ¶9161, 308 US 488, 495, 60 SCt 363], an expenditure is ordinary if the taxpayer can show that it was a "common and accepted" way to achieve a business objective. [*See Welch v. Helvering*, *supra*, 290 US 113.]

However, being "common and accepted" is not a *necessary* condition to ordinariness. In Rev. Rul. 73-517, for example, a public utility voluntarily paid the municipalities in which it operated one percent of its gross receipts. The utility stated that it made the payments simply in the hope of remaining the sole franchisee in those municipalities. It never claimed that such payments were common and accepted in the industry.

The IRS acknowledged that the utility's payments "might be viewed as unusual." But it still approved a deduction under Code Sec. 162(a). For the IRS, it was enough that the payments could reasonably be viewed as having been made "to protect and promote the taxpayer's business."

The fact that a payment is common and accepted in a taxpayer's line of business generally establishes that the payment was intended to protect and promote the payor's business. However, the fact that a payment is *not* common and accepted should not bar a deduction if the taxpayer can establish that it was paid to protect and promote its business. Advisor's $275 million payment would likely have qualified as "ordinary" even if it had been without precedent in the high-minded world of investment management.

Capitalization Under Code Sec. 263

A payment that is deductible under Code Sec. 162 is nonetheless subject to the exceptions set forth in Code Sec. 261 *et seq*. Chief among these is Code Sec. 263's prohibition of deductions for capital expenditures. The challenge is to determine whether a specific expenditure is "capital."

The Supreme Court has taken an expansive view, holding that an expenditure must be capitalized if: (1) it creates or enhances a separate and distinct asset [*see Lincoln Savings &*

Loan Ass'n, SCt, 71-1 USTC ¶9476, 403 US 345, 91 SCt 1893], or (2) it produces a significant future benefit [*see INDOPCO, Inc.*, SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039]. The lower courts have held that a taxpayer must also capitalize expenses incurred in the *acquisition* of a capital asset [*see, e.g., Ellis Banking Corp.*, CA-11, 82-2 USTC ¶9630, 688 F2d 1376].

Let's Get Practical

The abstract formulations in *Lincoln Savings* and *INDOPCO* were gratifying from a theoretical perspective. But attempts to apply them to real-world cases—notably cases involving *intangibles*—led to no end of controversy on audit and in the courts. In 2004, the Department of the Treasury abandoned the case-law regime in favor of a set of elaborate but intensely practical regulations. [*See* T.D. 9107, IRB 2004-7, 447.]

These "Anti-*INDOPCO* Regulations" (as some have dubbed them) provide detailed rules to govern the capitalization of expenditures to create, enhance, or acquire intangibles, as well as payments to "facilitate" certain M&A transactions. [*See* Reg. §1.263(a)-4 and 1.263(a)-5).] The Regulations, which are full of thresholds, safe harbors, and strictly defined terms, have been remarkably effective in reducing controversy in this area.

LTR 201736002 demonstrates that the IRS is still going by the book. If the IRS had any reservations about allowing an immediate deduction for $275 million paid to shareholders in a merger, they did not find their way into the ruling. The IRS applied the rules literally, without hesitation or comment, and let the revenue chips fall where they might.

Facilitating Acquisition of a Trade or Business

If it had been *Acquirer* that paid an extra $275 million to Target's shareholders, the payment would have become of its basis in its new Target shares. There would have been no question of Acquirer deducting and amortizing its expenditure, whether over 15 years or any other period.

In LTR 201736002, however, *Advisor* was the payor. Unlike Acquirer, Advisor was not purchasing stock. It was trying to *facilitate* the transaction by inducing Target's shareholders to approve the acquisition.

The corporate taxpayer in *INDOPCO* wasn't buying stock, either. In fact, it was the *target* of the acquisition. Nevertheless, the Supreme Court required the corporation to capitalize the substantial expenses it had paid. It didn't matter that the target was not an actual participant in the transaction, which was between the acquirer and the target's *shareholders*.

Amounts paid to facilitate the acquisition of a trade or business are the principal focus of Reg. §1.263(a)-5. A taxpayer must capitalize expenses incurred to facilitate a long list of capital transactions. The rules apply whether the transaction is accomplished in a single step or in a series of steps pursuant to a plan and without regard to whether gain or loss is recognized.

This sounds pretty rigorous. But it is always worth checking whether a transaction is actually on the regulatory list. If we limit ourselves to only the three most promising candidates, a transaction is covered if:

- The transaction involves the acquisition of assets constituting a trade or business, "whether the taxpayer is the acquirer in the acquisition or the target of the acquisition." [Reg. §1.263(a)-5(a)(1).]
- The transaction is the acquisition by the taxpayer of an ownership interest in a business entity if, after the acquisition, the taxpayer and the entity are related within the meaning of Code Sec. 267(b) or 707(b). [Reg. §1.263(a)-5(a)(2).]
- The transaction is the acquisition of an ownership interest in the taxpayer. [Reg. §1.263(a)-5(a)(3).]

None of these provisions applies unless the taxpayer is paying to facilitate a transaction in which it is either the *acquirer* or the *target*. The fact that the taxpayer is some *other* kind of party to the M&A transaction does not trigger capitalization under Reg. §1.263(a)-5(a). And, as the third provision makes clear, the fact that the taxpayer is not a party to the actual *transfer* does not excuse capitalization if the taxpayer is the target.

In LTR 201736002, Acquirer purchased all of the stock of Target. Advisor paid $275 million in connection with the merger, but it was neither the acquirer nor the target as described in Reg. §1.263(a)-5(a). Accordingly, Advisor's payment did not have to be capitalized, even though it was paid to facilitate the stock acquisition.

The IRS did not spell out this analysis in LTR 201736002. The letter ruling just says that the support payment was not made to facilitate any of the transactions listed in Reg. §1.263(a)-5(a). From a taxpayer's perspective, it is reassuring to see the IRS applying the regulation literally, without discussion, even when there is a $275 million deduction on the line.

Acquiring an Intangible

Reg. §1.263(a)-4(c)(1) requires a taxpayer to capitalize amounts "paid to another party to acquire any intangible *from that party* in a purchase or similar transaction." Advisor paid $275 million to the shareholders of Target. However, even if the transaction provided Advisor with an intangible benefit, it did not purchase that benefit *from* Target or its shareholders. The IRS therefore concluded that Advisor did not have to capitalize its expenditure under Reg. §1.263(a)-4(c)(1).

Creating an Intangible

Under Reg. §1.263(a)-4(b)(1)(ii), a taxpayer must capitalize an amount incurred to create an intangible described in Reg. §1.263(a)-4(d). In LTR 201736002, the IRS ruled that Advisor's support payments were not one of the types of created intangibles listed in that provision. The IRS looked to Reg. §1.263(a)-4(d)(6)(i)(B), which provides that a taxpayer must capitalize amounts paid to another party to enter into, renew, or renegotiate *with that party* an agreement providing the taxpayer with the right to provide or receive services.

The IRS began with the formal point that Advisor had not paid the $275 million to create, originate, enter into, renew, or renegotiate *with Target* any agreement involving the provision of services to *Target.* The IMA was an agreement between Advisor and *Acquirer,* not Target. In any event, Advisor did not receive anything in exchange for making the support payment.

The IRS acknowledged the possibility that Advisor might have been trying to preserve its profitable contract with Acquirer. But Advisor hadn't gotten anything in writing. The support payment had given Advisor "the mere hope and expectation" of renewing the IMA with Acquirer.

Under Reg. §1.263(a)-4(d)(6)(ii), a payment made with "a mere hope or expectation" of developing or maintaining a business relationship is *not* paid to create, originate, enter into, renew, or renegotiate an agreement. This is a good example of how the Anti-*INDOPCO* Regulations avoid fact-intensive controversies about what was *really* driving the taxpayer's expenditure. If the arrangement does not create a formal legal obligation, it does not trigger capitalization under Reg. §1.263(a)-4(d)(6)(i)(B).

Finally, the IRS pointed out that Acquirer retained the right to terminate the IMA on 60 days' notice. Under Reg. §1.263(a)-4(d)(6)(iv), a taxpayer is generally not required to capitalize a payment to facilitate the creation of any right or benefit that does not extend for at least 12 months. Hence, even if Advisor paid the $275 million with the firm expectation that doing so would keep the IMA in force, there was still nothing to prevent Acquirer from terminating the relationship well before the expiration of 12 months.

Separate and Distinct Intangible

Reg. §1.263(a)-4(b)(1)(iii) requires capitalization of an amount paid to create or enhance a "separate and distinct" intangible asset. Under Reg. §1.263(a)-4(b)(3)(i), an intangible is separate and distinct only if it is:

> a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business.

The IRS observed that Advisor had not received anything concrete in exchange for the support payment. Advisor had been trying to encourage Target's shareholders to vote in favor of the merger, which Advisor hoped would result in additional fees. But this hope fell far short of a legally protected property interest capable of being sold, transferred or pledged apart from Advisor's trade or business. Hence, the $275 million had not been paid to create or enhance a separate and distinct intangible asset.

Other Capitalization Triggers

Reg. §1.263(a)-4(b)(1)(iv) provides that a taxpayer must capitalize an amount paid to create or enhance a future benefit if it is identified in the Federal Register or in the Internal Revenue Bulletin as an intangible for which capitalization is required. LTR 201736002 agreed with Advisor that there was nothing in the Federal Register or the IRB to trigger this provision.

Under Reg. §1.263(a)-4(b)(1)(v), capitalization can also be required if an amount is paid to *facilitate* the acquisition or creation of an intangible. The IRS pointed out that Advisor had not acquired or created any intangible asset. Hence, Advisor's payment could not have been made to facilitate any such acquisition or creation.

Conclusion

The fact that Advisor (a.k.a. Ares Management) was permitted to deduct the $275 million it paid to Target's shareholders may seem a bit surprising at first. But if we take the regulations under Code Sec. 263 at face value, Advisor turns out to have a respectable case. The IRS plainly thought so.

In broader terms, LTR 201736002 reassures taxpayers that the IRS is not having second thoughts about the Anti-*INDOPCO* Regulations. A set of formal rules, mechanically applied, has relieved the IRS of a crippling administrative burden. Perhaps some eyebrows were raised at the prospect of a taxpayer deducting $275 million paid in a stock acquisition. But it seems clear that IRS has no interest in turning back the clock.