How to Treat Transaction Costs When Buying or Selling a Business

By George D. Show, CPA

With the recent uptick in M&A deal closings, many business owners are now faced with the question of how to treat the costs incurred as a result of their transaction.

Both parties in the transaction will incur accounting and legal fees. In many cases, they will also incur investment banking fees. If the investment bank does not provide a fairness opinion addressing the value of the company, a third party will be used. In addition, if shareholder approval is required, a proxy service provider will be retained.

The tax treatment of such fees will differ depending on the facts and circumstances of the case, as well as whether the buyer or the seller incurred the fees.

Taxpayers would generally prefer to deduct all costs immediately; unfortunately, with the exception of “success-based” fees, IRS regulations require that fees be capitalized. Generally, sellers may deduct their capitalized costs against capital gains. The deduction against capital gains is generally at a rate totaling about 25%, depending on the state, which is typically about 15% less than a deduction against ordinary income.

Buyers in asset-based deals may amortize their capitalized costs over 15 years on a straight-line basis. Buyers in stock-based transactions may add their capitalized costs to their stock tax basis. In such cases, the capitalized costs can be recovered only when the stock is sold.

In a middle market M&A deal, accounting, legal and investment banking fees typically add up to hundreds of thousands of dollars (see chart), so it’s worth knowing the rules even before a transaction takes place.

Capitalization vs. Deduction

IRS regulations require taxpayers to capitalize fees that are paid to “facilitate” a transaction, such as fees paid to investigate or otherwise pursue a transaction. Capitalized costs also include fees related to securing an appraisal, structuring and negotiating the transaction, and preparing and reviewing the transaction documents to obtain regulatory and shareholder approval.

A facts-and-circumstances test (Regs. Sec. 1.263(a)-5(b)(1)), which requires a review of invoices, is used to determine which fees were incurred to facilitate the transaction.

Tax treatment of success-based fees is more generous, so taxpayers typically try to maximize these fees. Success-based fees are those charged only if the company sale is completed. Typically, investment banks charge a retainer fee, which is capitalized, and an additional success-based fee, while lawyers occasionally discount their hourly fee in exchange for an additional success-based fee.

With full documentation, success-based fees may be fully deductible, but the hurdles for compiling such documentation are significant. Instead, a safe harbor election (Regs. Sec. 1.263(a)-5(f)) may be used that allows 70% of fees to be deducted and 30% to be capitalized.

To make the safe harbor election, taxpayers must attach a statement to their federal income tax return for the tax year during which the fee is paid or incurred stating that the taxpayer is electing the safe harbor, identifying the transaction.
and specifying the amounts capitalized and the amounts deducted.

**The “Bright Line” Date**

In addition, the IRS requires that costs incurred after a specific “bright line” date – including success-based fees – must be capitalized. This date is the earlier of:

1. the date on which a letter of intent, exclusivity agreement or similar written communication (other than a confidentiality agreement) is executed, or
2. the date on which the material terms of the transaction are authorized or approved by the taxpayer’s board of directors (or committee of the board of directors).

A common issue, particularly in middle-market deals, is that the transaction doesn’t always fit clearly under the “bright line” definitions. For example, regulations do not clearly specify when events used to determine the “bright line” date are considered binding and the degree to which they must be binding. In these circumstances, the “facilitate” criteria must be applied to all transaction fees incurred throughout the process.

In Letter Ruling 201250015, the IRS allowed a late election to use the safe-harbor method for success-based fees. The taxpayer failed to attach the election statement required under Rev. Proc. 2011-29 to the tax return for the year in which the success-based fees were incurred, but the IRS concluded that the taxpayer had acted “reasonably and in good faith.” The IRS also concluded that granting relief would not affect the amount of taxes paid by the taxpayer.

In addition, Chief Counsel Advice (CCA) 201234026 provides informal guidance from the IRS on application of the bright-line test and the impact of a contingency affecting the taxpayer’s obligation to complete the transaction in determining when the bright-line date occurs.

While we have been focusing on private, middle-market companies, CCA 201234026 is based on a merger agreement with a “go-shop” provision, which allows a public company that is being sold to seek competing offers even after it has a firm purchase offer. Because the go-shop provision did not impact execution of the merger agreement or affect approval of the agreement by both companies’ boards of directors, the IRS concluded that the bright-line date was the date the merger agreement was executed and approved by both companies’ boards of directors.

Properly applying IRS regulations and special elections to maximize the current tax deductibility of fees incurred in M&A deals can be complicated. It requires in-depth knowledge and expertise, and in many situations it comes down to a judgment call.

This is when business owners need M&A experts to guide them through the process in order to make the right call at tax time.

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