

Recoup your transaction costs...what to do with investment bank, attorney, and consulting fees

Business combinations and transactions present companies with unique opportunities for growth and diversification. In recent years, transactions have become larger and more complex requiring the assistance of legal counsel, financial advisors, and accounting professionals to successfully execute mergers and other transactions. These endeavors often produce great results, but come with the burden of high fees, integration obstacles, and increased reporting requirements. To address the increasingly complex and variable reporting environment, the Financial Accounting Standards Board delivered guidance on business combinations in 2001 with Financial Accounting Statement No. 141 (“FAS 141”).

FAS 141 broadly requires financial statements to provide users with a clear and uniform reporting of transaction costs. Under its guidance, business combinations are streamlined and accounted for under the purchase method of accounting, and transaction fees are bundled with the purchase price of the acquired assets or stock. Similar to U.S. federal tax law, such treatment allows companies to capitalize transaction fees and recover the costs ratably over a period of time.

In an effort to more closely align U.S. GAAP and international accounting practices, the Financial Accounting Standards Board revised FAS 141 in 2007. The revised statement, Financial Accounting Statement No. 141R (“FAS 141R”), diverges from U.S. federal tax law and significantly changes the treatment of fees incurred in a business combination. Unlike its predecessor, FAS 141R requires companies to separately recognize transaction fees incurred during a business combination and expense them immediately in the year the costs are incurred.

The effects of FAS 141R can extend beyond accounting and financial reporting departments. A prime concern is the advantage such expedient reporting provides to a company’s competitors. Under the new guidance, companies must report transaction-related expenses in the period incurred not upon the completion of the resulting transaction. If a transaction spans over multiple reporting periods, the related expenses must be disclosed in its financial statements. While FAS 141R adds transparency to business combination reporting for financial statement users, company leaders must be cautious of prying competitors who are more attuned to the reporting, classification, timing, and treatment of transaction costs.

Federal Taxation and FAS 141R

The heightened awareness of transaction costs, both internally and externally, has far-reaching effects on tax professionals. Because of the integration between financial reporting and taxation, the new reporting requirements oblige tax professionals to re-examine the effects of transaction costs on taxable income. Two additional tax considerations arise from FAS 141R:

(1) alleviating the tax effects of the expensed transaction costs, and (2) applying due diligence to ensure the proper tax treatment of transaction costs. FAS 141R, therefore, enhances the advantages and need for companies to conduct a Transaction Cost Analysis (“TCA”).

In brief, a TCA helps to distinguish the deductibility and capitalization of costs associated with transactions for federal tax purposes. In the absence of a TCA, the Internal Revenue Service (“IRS”) assumes that transactions will produce significant future benefits and, as such, require related costs to be capitalized. Transaction fees and expenses are treated as capital expenditures and are capitalized, much like an amount paid for the creation of an intangible asset, i.e., goodwill. Those fees are added to the basis of the acquired assets or stock and then amortized over a period of time, often 15 years, or recovered on the subsequent sale. However, with proper analysis, certain fees may qualify for an immediate deduction often resulting in significant cash savings.

Alleviating the Tax Effects of Expensed Transaction Costs

While FAS 141R moves us closer to the International Financial Accounting Standards, it diverges from traditional U.S. federal tax law. The former mandates that transaction costs are to be expensed; the latter requires, in general, those costs to be capitalized. The variation resulting from this divergence creates what is known as a “book-to-tax” difference. Consequently, taxpayers must first identify this difference and subsequently add back the transaction expenses to arrive at higher taxable income.

The effect of adding back costs to net income is staggering and will undoubtedly catch the attention of management. The unfavorable effects of this “add-back” forces tax practitioners to more closely analyze these expenses to identify those that can be currently deducted under U.S. federal tax law and subsequently ease the tax liability by reducing or zeroing the tax add-back. With the changes implemented under FAS 141R, a transaction cost study is more important and beneficial than ever.

Applying Additional Due Diligence

The transition-in-business-combination accounting means that stakeholders, including the Internal Revenue Service (“IRS”), are more attuned to the reporting of transaction costs. Though stakeholders across the board are more conscious of its effects, the concerns are generally varied or diverse. Management and shareholders may consider these effects as they relate to strategy, earnings, and tax expense, focusing on planning and net income in a FAS 141R environment. On the other hand, the IRS is interested in whether companies are properly classifying and reporting these costs to confirm that the tax add-back is recognized, reported, and taxes due are paid. Both objectives require companies to apply additional due diligence and effort in transaction planning and reporting.

To mediate the various goals of a company’s stakeholders, due diligence can be accomplished with a complete and thorough transaction cost analysis to support a company’s tax position. As the IRS examines transaction costs more closely, it is extremely important for companies to provide adequate and sufficient documentation to support their federal tax position. Such an

analysis will have favorable results for managers, mitigating the results of the add-back, while justly complying with federal tax law.

Conclusion

The variable field of business and the global convergence of accounting doctrine are forces behind any change in accounting methodology and reporting. It is vital that companies are able to react to these transitions and implications such as those imposed by FAS 141R. Prior to the implementation of FAS 141R, the benefit of a TCA was grand, but not dire. If a company chose to perform the analysis, it would benefit from the tax savings arising from an immediate deduction. Often times companies were reluctant to pursue a TCA because of the burdensome documentation requirements outlining the time and expenses spent on the transaction. However, as stakeholders become more conscious of the effects of acquisitions and business combinations, the proper analysis and documentation of transaction fees will prove to be even more valuable than ever before.

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