Transaction Cost Allocation Considerations for Partnerships — What’s Different and What’s the Same

The treatment of transaction costs in the context of a transaction involving a partnership that is either the acquiring entity or the target entity raises unique issues. In addition to the general issues raised in determining the proper allocation of transaction costs for U.S. federal income tax purposes, unique questions can arise with respect the treatment of costs incurred in a partnership transaction.

This article provides a brief overview of the importance of properly characterizing transaction costs in cases in which a partnership is either the acquiring or target entity and identifies potential pitfalls specific to transactions involving partnerships. This article also addresses a small subset of potential issues that must be analyzed in connection with a determination of the proper characterization of transaction costs for a particular taxpayer.
**Syndication Costs vs. Organization Costs vs. Transaction Costs**

A partnership cannot deduct syndication costs, which are generally defined as amounts paid or incurred to promote the sale of a partnership interest. Examples of syndication expenses include brokerage fees, registration fees, legal fees of the underwriter or placement agent, accounting fees for preparation of representations included in the offering materials, and printing costs for the prospectus and other promotional materials.¹

A different treatment is provided for costs incurred to organize a partnership. Organization costs are costs chargeable to the capital account if such costs “are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.”² Unlike syndication expenses, which cannot be amortized or deducted by the partnership, certain organization expenses may be amortized over 180 months. Examples of organization costs are costs of filing required documents with the state or opening a bank account.

Distinguishing between organization and syndication costs requires a detailed factual analysis. Taxpayers undergoing this analysis must consider whether a particular cost relates to raising capital for the formation and funding of the partnership (by, for example, issuing equity interests) or, if instead, it relates to the partnership’s organization.³ While the former is likely a nondeductible syndication cost, the latter may be amortized as an organization cost.

A separate category of costs includes those incurred in connection with the sale or purchase of partnership assets or partnership interests, or a purchase of another entity or group of assets by a partnership. A partnership that is a party to a transaction must evaluate any transaction costs under the transaction cost allocation rules to determine the proper federal income tax treatment for such costs. The evaluation must take into account the structure of the transaction, the services performed, detailed information on the role of each of the service providers, the timing of the services performed, the source of the payment for such services, and other factors.

**Evaluation of Transaction Costs in General**

The primary rules addressing the treatment of transaction costs are found in Treasury Regulations section 1.263(a)-5, et seq., which provides a regulatory regime for the treatment of transaction costs incurred to facilitate an acquisition of a trade or business.⁴ Examples of typical transaction costs include due diligence costs, accounting costs, employee benefit and employee consulting fees, IT evaluation fees, investment advisory...
fees, legal fees and tax-planning costs. The Internal Revenue Code, Treasury Regulations, Service rulings and case law have historically found that taxpayers may divide transaction-related costs into three categories: (i) costs deductible under sections 162 and 165; (ii) costs capitalizable and amortizable under sections 167, 168, 195, 197, 248 or other authorities; and (iii) costs capitalizable under section 263, INDOPCO v. Commissioner and other authorities. If no allocation is made for transaction costs, these costs are treated as capitalized.

Section 162(a) generally allows a current deduction for ordinary and necessary business expenses incurred in a taxpayer’s trade or business. A cost that is otherwise deductible may not be immediately deducted if it is considered a “capital expenditure” — a cost that yields future benefits to the taxpayer’s business. Section 263 requires capitalization of certain nondeductible expenditures.

Under Treasury Regulations section 1.263(a)-5(a), a taxpayer must capitalize an amount paid to facilitate any one of 10 specified transactions. The Treasury Regulations clarify that investigatory costs are considered facilitative unless there is a specific exception. Treasury Regulations section 1.263(a)-5(e) provides a significant exception for certain investigatory costs that are incurred prior to a “bright-line” date in connection with “covered transactions.” Investigative costs generally include due diligence, preliminary review of customer relationships, evaluation of management, review of legal risks, review of financial information, review of potential strategic opportunities in the target entity’s industry, etc. These costs can be eligible for deduction under section 162 if the transaction is an expansion of the taxpayer’s existing business, or may be eligible to be capitalized and amortized under section 195 if the costs are startup costs associated with evaluating entering into a new business.

A “covered transaction” includes (i) “[a] taxable acquisition by a taxpayer of assets that constitute a trade or business,” (ii) a taxable acquisition of the ownership interests in a business entity (whether the taxpayer in the acquisition is the acquirer or the target) where the acquirer and the target are related within the meaning of section 267(b) or 707(b) immediately after the transaction, and (iii) a reorganization generally described in sections 368(a)(1)(A), (B), (C), and, in certain instances, section 368(a)(1)(D). Consequently, when there is a covered transaction, certain investigatory costs can be eligible for an immediate deduction. However, if those costs are startup costs that are incurred before the bright-line date and are not otherwise inherently facilitative, they may be amortized as startup costs. Importantly, for purposes of evaluating whether a transaction
involving a partnership is a covered transaction, Treasury Regulations section 1.263(a)-(5)(e)(3)(ii) contemplates a covered transaction that includes a taxable acquisition where the acquirer and the target are related within the meaning of section 707(b) immediately after the transaction.

Success-Based Fees

Special rules apply to success-based fees. In general, an amount that is contingent on the successful closing of the transaction is presumed to facilitate the transaction and, thus, cannot be immediately deducted. However, a taxpayer that maintains sufficient documentation supporting a position that part of the success-based fees is allocable to nonfacilitative activities can rebut the presumption and treat a portion of these fees as nonfacilitative of the transaction. In order to take a position with respect to success-based fees that treats these fees as other than capitalized, information demonstrating that the underlying services are deductible or amortizable as startup costs must include detailed invoices or other records that include names and addresses of those providing the services, detailed descriptions of the services provided, the fees that are allocable to each of the listed services performed, and the timing of the services provided.  

Because of the difficulty of obtaining the detailed information needed to support an allocation of success-based fees, the IRS provided taxpayers with the ability to elect a safe harbor for success-based fees incurred in “covered transactions,” pursuant to Revenue Procedure 2011-29. The safe harbor election permits a taxpayer to allocate a success-based fee between activities that facilitate the transaction and activities that do not facilitate the transaction by treating 70 percent of the amount of the success-based fees incurred in a “covered transaction” as an amount that does not facilitate the transaction and by capitalizing the remaining 30 percent as an amount that does facilitate the transaction. Therefore, if the partnership engaging in a covered transaction cannot obtain the required documentation from those service providers that were paid a success-based fee in order to document that a portion of those fees is not capitalizable, the partnership can make the election and treat 70 percent of the success-based fees as nonfacilitative.  

Pepper Perspective

The threshold issue in evaluating costs incurred in a transaction involving a partnership as the target or the acquiring entity is separating organization and syndication costs from transaction costs. This threshold issue is factually driven and requires a detailed analysis of the structure of the overall transaction. For example, is a new partnership being formed to effectuate the acquisition or sale transaction? If so, do the service providers
detail their services sufficiently to distinguish organization and syndication costs (if any) from costs associated with considering, negotiating and ultimately consummating the transaction? Do the same service providers perform organization, syndication and/or transaction-related services? If so, what documents and facts can be assembled to draw a distinction between the services related to each type of activity? As is always the case with the proper federal income tax treatment of transaction costs, the facts needed to determine the origin of the claim of the expense must be assembled and evaluated to support the proper allocation of costs incurred.

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Endnotes
1 Treas. Reg. § 1.709-2(b). Unless otherwise noted all “section” references herein are to a section of the Internal Revenue Code, of 1986, as amended (the Code), and all references to “Treas. Reg. Section” and “Regulation” are to U.S. Department of the Treasury regulations promulgated thereunder, all in effect through the date hereof.

2 Section 709(b)(3).


4 See generally Section 162 and the Regulations thereunder for the applicable rules and regulation. Other relevant Code sections include, but are not limited to, sections 165, 263, 709 and 195.


6 Treas. Reg. § 1.263(a)-(5)(a).

7 Treas. Reg. § 1.263(a)-(5)(b), (e).

8 The “bright-line” date is defined in Treas. Reg. § 1.263(a)-(5)(e), as the earlier of “(i) The date on which a letter of intent, exclusivity agreement, or similar written commu-
lication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or (ii) The date on which the material terms of the transaction... are authorized or approved by the taxpayer’s board of directors."

9 Treas. Reg. § 1.263(a)-(5)(e)(3).

10 Inherently facilitative costs include costs paid for a fairness opinion, structuring the transaction, preparing and reviewing acquisition documents, obtaining regulatory approval, obtaining shareholder approval, transfer taxes, etc. Treas. Reg. § 1.263(a)-(5)(e)(2).

11 Treas. Reg. § 1.263(a)-(5)(f).

12 See IRS Priv. Ltr. Rul. 2018-27-009 (Apr. 3, 2018), where the IRS allowed 9100 relief to make the Rev. Proc. 2011-29 election for a taxpayer that was acquired by a SM-LLC that was held by a partnership.