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Transaction Costs (Not) Deductible by Target: *Plano Holding LLC v. Commissioner*

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In general, amounts paid to "facilitate" an acquisition of assets constituting a trade or business or an ownership interest in a business entity must be capitalized and may not be deducted currently (Internal Revenue Code ("Code") § 263; Reg. § 1.263(a)-5). These amounts include facilitative costs contingent on the successful completion of a transaction ("success-based fees"), such as a typical finder's fee or broker fee.

Some costs are not treated as "facilitating a transaction" and may be currently deductible. These costs include employee compensation, the costs of integrating business operations, and costs of investigating a potential transaction that are incurred before a letter of intent is executed or the material terms of a transaction are otherwise agreed upon. A success-based fee may be allocable to various activities, some of which are treated as "facilitative" and some of which are not.

In order to minimize controversies regarding the treatment of success-based fees, Revenue Procedure 2011-29 (2011-18 I.R.B. 746) provides a safe harbor under which a taxpayer may elect to treat 70% of certain success-based fees as amounts that do not facilitate a transaction (and that are therefore potentially deductible). If the election is made, the remaining 30% of such fees must be capitalized as facilitative costs. The Revenue Procedure is only one element in the analysis, however; other circumstances may also affect whether a deduction is available.

The parties to a transaction frequently have substantial flexibility in specifying in the transaction documents the party to the transaction that will pay a particular fee. Sometimes that flexibility is used with the expectation of achieving a better tax result. In a recent Tax Court memorandum decision (*Plano Holding LLC v. Commissioner*, TC Memo 2019-140), a payment in the nature of a finder's fee was made by a target entity in an acquisition, in circumstances that suggested that the payor was designated with a view to achieving a favorable tax result. The desired deduction was disallowed, and an accuracy-related penalty was sustained.

Facts in *Plano*

The Ontario Teachers' Pension Plan Board ("OTPP") is a large institutional investor. In 2012 OTPP received a suggestion from Robert W. Baird & Co., Inc. ("Baird"), a financial advisor, that Plano Molding Co. ("Plano"), an Illinois plastics manufacturer, be considered as a potential acquisition candidate. Baird had been retained two years earlier, in 2010, as Plano's financial advisor "with an eye to" a potential sale of the company, but no sale had occurred in that year.

After Baird contacted OTPP, representatives of OTPP and of the investment firm that was then the majority shareholder of Plano discussed the potential acquisition. Baird did not participate in that call and had no further input regarding the acquisition as ultimately implemented.

Plano engaged Harris Williams LLC as Plano's investment banker and financial advisor, and Harris Williams proceeded to discuss the possible acquisition of Plano with OTPP. A merger agreement was entered into on November 20, 2012, under which Plano would be acquired for a purchase price of $240 million, subject to adjustments.

The merger agreement provided that Plano would become a wholly owned subsidiary of Plano Holding LLC ("Holding"), a Delaware limited liability company controlled by OTPP that elected to be taxed as a corporation for Federal tax purposes. One of the adjustments provided for in the merger agreement was to reduce the purchase price for all unpaid fees and expenses incurred by Plano or its subsidiaries in connection with the merger.

A few days after the execution of the merger agreement, Baird and OTPP agreed that Baird would receive a payment of $1.5 million upon the completion of the acquisition. The agreement recited that Baird's services were provided solely for the benefit of, and use by, OTPP's management and directors

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in considering the transaction, and further provided that OTPP could not assign its obligations under that agreement to anyone without Baird's consent. The court ultimately found that Baird's activities, for which it was to be compensated under that agreement, were limited to suggesting Plano to OTPP as an acquisition target, evaluating the interest of Plano's majority shareholder in effecting a sale, and attempting to set up a meeting between representatives of OTPP and the majority shareholder.

At the closing in December 2012, Plano made two payments to financial advisors: a payment of $2.89 million to Harris Williams for its services in connection with the merger, and a payment of $1.5 million to Baird pursuant to the Baird/OTPP agreement. The fee paid to Harris Williams was taken into account under the merger agreement as a transaction expense that reduced the purchase price for Plano; the fee paid to Baird was not so taken into account.

Holding filed a consolidated Federal tax return for 2012 with Plano and other subsidiaries of Holding in which 70% of the Baird fee was deducted pursuant to an election under Rev. Proc. 2011-29. The IRS subsequently issued to Holding a notice of deficiency for 2012 that disallowed the claimed deduction of 70% of the Baird fee. The IRS asserted that Plano had not established that the fee was incurred "for ordinary and necessary business purposes and/or that any amount qualifies as a business expense under the provisions of the Internal Revenue Code," and determined a tax deficiency and an accuracy-related penalty. Holding petitioned the Tax Court for redetermination of the deficiency and penalty.

Discussion

Based on the record before the court, including that the Baird fee was due under an agreement entered into by Baird with OTPP, the court concluded that the fee was an expense that Plano paid on behalf of OTPP. Plano argued that OTPP assigned its obligations under that agreement to Plano, but did not provide support that the assignment occurred. (The opinion does not discuss whether such an assignment, if established, would have affected the result.)

In general, a taxpayer may not deduct an expense of another person. Notwithstanding this rule, *Lohrke v. Commissioner* (48 T.C. 679 (1967)) and other cases summarized by the court in *Plano* have held that payment of an obligation of another person may be deductible by a taxpayer where (1) the primary motivation underlying payment is protection of the taxpayer's own business, and (2) the expenditure is an ordinary and necessary business expense of the business of the taxpayer.

The court concluded that the payment by Plano of the Baird fee met neither of the *Lohrke* requirements. Although the acquisition of Plano by OTPP may have benefited Plano by providing it with a deep-pocketed investor that would allow Plano to expand, the circumstance that the acquisition was agreed to before OTPP agreed to pay the fee to Baird led the court to conclude that the acquisition was not contingent on Plano's making the payment to Baird. It was also not helpful that Plano's obligation to Baird did not exist prior to closing and that payment thereof apparently did not affect the net consideration received by Plano's shareholders.

The court also concluded that the expense was not an ordinary and necessary business expense of Plano. In particular, the court found that the payment was not attributable to Baird's efforts in 2010 to locate a buyer of Plano. To the contrary, the opinion notes that "the parties agree that the Baird payment came about because OTPP felt obligated to Baird for its legwork (in 2012) in identifying a potential acquisition for OTPP."

Further, Baird provided no services in connection with the merger itself. Rather, the nature of the matchmaking service provided by Baird in suggesting Plano to OTPP as a potential acquisition had a stronger apparent relationship to OTPP's activities as a large institutional investor than to Plano's activities as a manufacturer of plastic goods.

The court concluded that the payment by Plano of the Baird fee was not deductible as an ordinary and necessary business expense of Plano. A footnote in the opinion observes that the government did not argue that the payment by Plano of the Baird fee was a constructive dividend to OTPP, and therefore that the court was not considering that issue.

The asserted accuracy-related penalty would not be imposed if there was "substantial authority" for the treatment of the fee on the consolidated return filed by Holding. The court concluded that the cases cited by Holding (and discussed in the opinion) as supporting a deduction of transaction costs were materially distinguishable from the facts before the court, and that Holding had failed to establish that it had such authority for the treatment of the Baird fee in Holding's consolidated tax return. (A footnote in the opinion characterized a statement in Holding's brief, that Plano's "CPA firm" prepared the 2012 tax return, as "an undercooked attempt" to establish the applicability of an exception to the penalty that applies when a taxpayer has "reasonable cause" for an underpayment, and observed that Holding failed to establish that the CPA firm provided any advice to Holding regarding the deduction.)

Observations

The decision in *Plano* does not appear surprising, based on the circumstances set forth, and should probably not be interpreted as an indication that the IRS is likely to challenge the more common situation where transaction expenses benefiting, at least in part, the shareholders of the target are paid by the target itself. The decision is also a reminder that, notwithstanding (and perhaps partly by reason of) the availability in many instances of an election under Rev. Proc. 2011-29 to deduct a portion of success-based fees for an acquisition, the IRS continues to scrutinize the tax reporting of acquisitions and, in particular, the deduction of expenditures attributable to success-based fees and other transaction expenses.