Pepper Hamilton LLP
Attorneys at Law

Transaction Cost Deduction Denied – Tax Court Found Finder's Fee Paid by Target Was Not Paid for Benefit of Target

Lisa B. Petkun | petkunl@pepperlaw.com

Plano Molding Co. (target), a manufacturer of plastics, was acquired by Plano Holding, an affiliate of the Ontario Teachers' Pension Plan Board (buyer), from Tinicum Capital Partners (seller). The target paid a fee to Robert W. Baird & Co. and elected the safe harbor as provided in Revenue Procedure 2011-29[1] to treat 70 percent of the fee as nonfacilitative and 30 percent as facilitative. In *Plano Holding LLC v. Commissioner*,[2] the Tax Court held in a memorandum opinion that the target could not deduct the fee paid to Baird, a financial adviser that entered into an agreement with the buyer, in connection with the acquisition. The Tax Court found that the fee was paid on behalf of the buyer and did not satisfy the factual requirements that the fee must benefit the business of the target and constitute an ordinary and necessary expense of the target under section 162.

Plano Facts

Baird had a prior relationship with the target in 2010 and worked on a potential sale transaction that did not occur.[3] In 2012, Baird suggested the target as an acquisition candidate to the buyer. Subsequently, Baird assessed the buyer's interest in the target for an acquisition and attempted to set up a meeting between the buyer and the target's majority shareholder. The meeting did not occur, but a phone call was held between the buyer and the seller, without Baird. In July 2012, the target retained a separate investment banker, Harris Williams LLC, to assist in a sale of itself. The buyer and the target entered into a merger agreement on November 20, 2012. The deal closed in late December 2012, and, as a result, the target become a wholly owned subsidiary of Plano Holding, an affiliate of the buyer. On November 28, 2012, shortly after the merger agreement was signed, Baird and the buyer entered into an agreement for the buyer to pay Baird $1.5 million upon closing for Baird's services in connection with the acquisition. The agreement with Baird provided that the fee would be paid upon a successful acquisition of the target. The agreement explicitly provided that the buyer and Baird "agree and acknowledge that *** this letter is solely for the benefit of the parties to this letter." In addition, the agreement could not be assigned. The Tax Court summarized the role of Baird as consisting of only the following activities:

> (1) suggesting Plano as an acquisition target to [the buyer], (2) gauging Tinicum's interest, and (3) attempting to set up lunch between [the buyer] and Tinicum representatives. At no time did Baird provide any financial advisory services (or other services) to [the buyer] with respect to the acquisition.

At closing, the target made payments to both Baird and Harris Williams LLC. The target paid $1.5 million to Baird and $2.89 million to Harris Williams LLC. In the merger agreement, the parties agreed to reduce the purchase price for the target's transaction expenses, which were paid out of closing funds. The fee paid to Harris Williams LLC was treated as a transaction expense that reduced the purchase price, but the Baird fee was not treated in this way and, thus, did not reduce the purchase price.

Plano Holding and the target filed a consolidated federal income tax return in which a business expense deduction was claimed for a portion of the Baird fee. On its tax return, the target deducted 70 percent of the fee paid to Baird as an ordinary and necessary business expense under section 162 and capitalized the remainder pursuant to an election under Revenue Procedure 2011-29.[4] The IRS disallowed the deduction.

Court's Analysis

The Tax Court noted that the parties had stipulated that the buyer entered into an agreement to pay Baird, and, thus, the target was attempting to take into account an expense that was incurred by another taxpayer, *i.e.*, the buyer. Although the general rule is that such a payment is not deductible, the Tax Court recognized that it has sanctioned a narrow exception to this rule in the case of *Lohrke v. Commissioner*, 48 T.C. 679 (1967), and other cases. To satisfy the tests of *Lohrke*, (1) the taxpayer's primary motive for paying the other's obligation must be to protect the taxpayer's own business and (2) the expenditure must be an ordinary and necessary expense of the taxpayer's business.

As to the first prong of the *Lohrke* test, the Tax Court used a very narrow construction in determining that the target was not protecting its business in making the payment. The Tax Court noted that a common way to satisfy this requirement is to show that the taxpayer's business would have faced "direct and proximate" adverse consequences had the payment on behalf of the other taxpayer not been made. In the present case, however, the target did not demonstrate any adverse consequences to its business if the fee was not paid. In addition, the target failed to establish that the buyer would have decreased its financial backing or reduced its plans had the target not paid the fee.

The target argued that its payment to Baird facilitated the acquisition of the target by the buyer, and that the acquisition provided a benefit to the target's business. The court rejected this reasoning, observing that because Baird's services ended five months before the merger was consummated, "we discern no benefit to [the target] from the Baird payment, as distinguished from the merger itself." Rather, the primary benefit from the fee payment was to the buyer, and not to the target.

As to the second prong—that the payment must be an ordinary and necessary expense of the target's business—the court similarly dismissed that argument. The Tax Court held that the fee was in the nature of a finder's fee that the buyer determined to pay after the acquisition agreement between the buyer and the seller had been signed. The court noted that if the buyer was attempting to deduct the fee paid to Baird, an argument might be asserted that such a payment was ordinary and necessary to a taxpayer that is in the business of being an institutional investor. However, when the fee was viewed in connection with the target's business of manufacturing plastic goods, the Tax Court viewed such a finder's fee as not constituting an ordinary and necessary expense of that line of business.

Plano Holding attempted to use the case of *Square D Co. v. Commissioner*, 121 TC 168 (2003), in support of the deduction. In *Square D*, a corporate parent was able to deduct fees in connection with a loan that it negotiated on behalf of its subsidiary, which had not yet been organized. When the subsidiary was created, it received the loan proceeds and paid and deducted the fees. In ruling for the taxpayer, the Tax Court in *Square D* found that the parent paid the fees because the subsidiary was unable to make the payment. The court in *Plano Holding LLC* distinguished *Square D*, noting that the buyer acted on its own behalf, and not on behalf of the target, in agreeing to make the Baird payment because the target provided no factual support to demonstrate that the payment was for the benefit of the target's manufacturing business or any information that indicated that the buyer was acting as an agent for the target in incurring the obligation for the fee. In addition, the fee was not treated by the parties as a target transaction cost under the defined terms of the merger agreement.

Penalties Imposed

Not only was the deduction for the fee disallowed, but the Tax Court upheld the imposition of the accuracy-related penalty. The target asserted that several cases and a private letter ruling constituted substantial authority in support of the deduction, but the Tax Court found that, in each of the cited authorities, the facts were materially distinguishable from the facts of *Plano Holding LLC*. The court rejected as "an undercooked attempt" Plano Holding's assertion that, because its CPA firm prepared its tax return, it satisfied the reasonable cause and good-faith exception to the penalty. The exception could not be used, according to the court, because there was no demonstration that the target's CPA rendered any advice regarding the deduction prior to the target's taking the deduction on its 2012 tax return.

Pepper Perspective

The *Plano Holding LLC* case presents a cautionary example of the necessity of documenting the tax positions for transaction costs before filing the tax return taking these costs into account. Longstanding authorities on the "origin of the claim," the "direct and proximate test," and what is "ordinary and necessary" under section 162 must be considered and analyzed before taking a deduction for a transaction cost. Because the general rule is capitalization under section 263, any deductions must be fully supported with facts and analysis. Although it is routine to have certain costs incurred in an acquisition transaction "pushed down" to the target from the buyer, in each of the decided cases and other situations in which the taxpayer was successful, the target was able to demonstrate that the subject costs provide specific benefits to the target's business and the documents assembled support that position.

In *Plano Holding LLC*, a significant contributor to the disallowance of the deduction of the fee was the language of the Baird agreement with the buyer. The agreement provided that Baird's services were rendered solely for the benefit of the buyer's management and that the agreement was solely for the benefit of the parties to it. These provisions enabled the court to conclude that Baird's services did not benefit the target and were not intended to benefit the target. The target also did not provide specific information that demonstrated the benefits to its business from the payment of the fee. Thus, the Tax Court found that that payment of the fee did not meet the *Lohrke* tests and that the payment was distinguishable from the *Square D* facts. As noted, significant factual and analytical development must be prepared before taking a deduction for transaction costs. In particular, when one party pays an expense that was originally incurred by another party, the taxpayer taking the expense into account must demonstrate how the payment of the expense is related to its business and why the payment benefits that business.

Endnotes

1 2011-18 I.R.B. 746.

2 T.C. Memo 2019-140 (Oct. 16, 2019).

3 As a point of interest, the Tax Court noted in a footnote, "Our holding today accordingly should not be seen to opine on whether a payment stemming from Baird's 2010 efforts on behalf of Plano would have been an ordinary and necessary expense of Plano's business."

4 The case did not include information as to whether the target made the election provided in Revenue Ruling 2011-29 for the success-based fee paid to Harris Williams LLC.