Mergers and acquisitions: the deductibility of transaction costs

OMB Large Corporate

23 March 2023

In part two of the series on mergers and acquisitions, we look at the deductibility of transaction costs and how this has changed following the decision in *Centrica*.

Key Points

What is the issue?

The scope for companies deducting transaction costs in relation to acquisitions or disposals has been narrowed by the recent Court of Appeal decision in *Centrica*.

What does it mean for me?

If you advise companies on the acquisition or disposal of investments, you should consider to what extent professional and other costs will be able to be deducted for tax purposes. Early planning may increase deductibility.

What can I take away?

Some transaction costs may be deductible as loan relationship debits, which have no capital/revenue distinction. Some may be treated as management expenses although, in practice, this may be limited. Management expenses are subject to a capital restriction which, following the Court of Appeal decision in *Centrica*, may mean that all costs arising after a commercial decision has been taken to buy or sell are not tax deductible.

This article is the second in a series of three exploring some of the tax issues faced by companies or groups in relation to mergers and acquisitions. This article focuses on the corporation tax deductibility of the various transaction costs arising in an M&A context.

Where costs are recharged to other members of the corporate group, the tax deductibility analysis should be relevant only to the company ultimately bearing the costs.

Transaction costs incurred

M&A transactions will inevitably give rise to a range of professional and other costs relating to the transaction, whether incurred by the buyer (buy-side) or the seller (sell-side).

Common examples of such costs include:

- pre-sale restructuring of the target;
- debt financing costs;
- project management;
- consultancy/advisory costs;
- legal services;
- corporate finance advice, which may include fees linked to the success and value of the transaction;
- financial, tax, commercial and operational due diligence;
- share purchase agreement support;
- tax and investment structuring;
- equity co-investment and equity commitment costs;
- vendor due diligence;
- vendor tax advice; and
- post-completion integration costs.

Costs relating to debt finance

Some of the above costs, or elements of them, will relate to debt financing – these could be the financial institution's costs of issuing new debt or refinancing existing debt, or associated legal and tax advisory fees.

Amounts arising in respect of loan relationships are deducted from profits as they are recognised in the company's accounts. Such amounts include 'expenses incurred by the company under or for the purposes of those relationships and transactions' (Corporation Tax Act (CTA) 2009 s 306A). The legislation includes a list of these expenses, which can only be deducted if, amongst other things, they are incurred in bringing any loan relationship into existence or making payments under the loan relationship.

HMRC's guidance in its Corporation Finance Manual at CFM33060 includes a non-exhaustive list of examples of the above expenses, which includes arrangement fees with banks, fees or commissions for loan guarantees, legal fees on the transfer of a security and early redemption penalties.

The loan relationship legislation makes no distinction between capital and revenue items but does distinguish between trading and non-trading costs.

As a result, costs directly related to the cancellation or elimination of existing debt, or of obtaining new debt facilities should be deductible when expensed in the accounts. Furthermore, to the extent that costs are incurred on behalf of third parties for the purposes of effecting a refinancing, it should be reasonable to treat these as costs of obtaining new debt facilities.

There are a number of provisions that can deny deductibility of finance costs, such as the anti-hybrid, thin capitalisation, unallowable purpose and corporate interest restriction rules, all of which will be covered in the third article in the series.

Expenses of management

Transaction costs are most commonly incurred by a company carrying on an investment business rather than a trading company. Where a company's business consists 'wholly or partly of making investments' (CTA 2009 s 1218), such that it is a 'company with investment business', it can deduct the expenses incurred in the management of its investment business for tax purposes.

Management expenses are not defined in legislation but are limited to those incurred in respect of:

- so much of the company's investment business as consists of making investments; and
- investments which are not held for an unallowable purpose.

HMRC accepts that the holding of shares which generate dividends or gains which are exempt from tax would not cause the investment to be treated as being for an unallowable purpose.

Historic case law has provided some guidance as to what constitutes expenses of management. The cost of acquiring an investment, including stamp duty and brokerage fees, cannot be a management expense (*Sun Life Assurance Society v Davidson* (1957) 37 TC 330). There must also be an identifiable connection between the expense and the investment business (*Dawsongroup v HMRC* [2010] EWHC 1061).

However, the most notable (and relied upon) case in relation to management expenses, until recently, was *Camas v Atkinson* [2004] EWCA Civ 541. The *Camas* case determined that:

- expenses incurred in contemplation of an acquisition should be treated as expenses of management, as part of managerial decision making; and
- the date on which a decision was taken to acquire a particular target is generally (but not always) seen to be the point at which subsequent costs relate to the acquisition stage and are therefore no longer expenses of management.

The above applies equally to both acquisitions and disposals. It is generally accepted that a number of transaction costs in the list above, e.g. due diligence costs incurred prior to agreeing heads of terms or any general management consultancy or advisory costs of running the target's business, can therefore qualify as expenses of management.

Practical position

However, in reality, it is likely that the majority of the expenditure will have been incurred only once a decision has been taken in relation to acquiring a particular target company, due to the nature of the work involved.

Where acquisition costs are incurred by a newly formed Bidco, as is often the case, it is normally also the case that Bidco is not formed until a decision has been made to acquire a specific target business. Due diligence costs are not likely to be regarded as expenses of management or loan relationship debits, especially where these are not conditions precedent of the external lenders and the lenders do not seek to rely on the findings. Similarly, a share purchase agreement would not normally be drafted, or require support, until the acquisition was determined. Tax and equity co-investment structuring work is also not likely to be required until the target has been decided.

Further difficulties may arise in determining whether, and how, individual costs can be split between those relating to the equity and the debt elements of the investment, with the result that it may be prudent to treat the costs as neither debt-related costs nor expenses of management.

Capital expenditure

When the management expenses legislation was originally drafted, in the Income and Corporation Taxes Act 1988, there was no provision prohibiting a deduction for expenses of a capital nature. This restriction was introduced into CTA 2009 s 1219(3) by Finance Act 2004, as a result of the *Camas* case, and took effect from 1 April 2004. HMRC guidance in the Company Taxation Manual at CTM08190 confirms that there are now two questions to be considered:

1. Is the expenditure an expense of managing the investment business?
2. Is the expenditure capital in nature?

The first substantive case law which includes the issue of capital expenditure is *HMRC v Centrica Overseas Holdings Limited* [2022] EWCA Civ 1520 and its related appeals – the latest judgment being the Court of Appeal decision released in November 2022 (see bit.ly/3n2TSeN). The details of the case are not repeated in this article, but it concerned various sell-side costs in relation to the disposal of a loss-making subsidiary. The Court of Appeal considered the two questions above in relation to these costs.

The Court rejected HMRC's appeal that certain costs were not expenses of management and accepted that the First-tier Tribunal (and the Upper Tribunal) had properly applied the legal principles arising from earlier case law, such as *Camas*, in determining that most of the costs could be argued to be expenses of management.

However, in relation to whether the expenditure was capital in nature, the court upheld HMRC’s appeal and applied the principles derived from centuries of case law relating to the revenue/capital divide in trading businesses. The court not only accepted HMRC’s argument that certain costs were capital in nature but went further and concluded that, once a commercial decision was taken to sell the business (even before identifying a specific purchaser), the related expenses were capital in nature and therefore disallowable. The court was clear that a different test applied to that used to determine whether the costs were management expenses. Companies should therefore avoid premature statements of intention to buy or sell.

The current position

The Court of Appeal’s judgment produces the result that expenses incurred before a decision is taken to sell a business to a specific purchaser qualify as expenses of management, but expenses incurred after a commercial decision is taken to sell the business (even if no purchaser is identified) are capital in nature. Based on this approach, the scope for deductibility will, in nearly all cases, be decided by applying the revenue/capital analysis.

This decision has significantly brought forward the point from which most advisors would previously have considered that expenses of management would be considered not to be tax deductible.

Although this case concerned sell-side costs, the same principle (although obviously untested) is expected to apply to buy-side costs. Once it has been determined that an acquisition will be made, even before the target business has been identified then, applying the decision in *Centrica*, the transaction costs from this point are likely to be treated as capital expenditure.

Reviewing options for investments (including potential transactions) should not, on its own, create an issue. Where it can be shown (with sufficient evidence) that the relevant fees were incurred to help inform the decision as to whether to buy or sell a business, rather than how to buy or sell it, then there may be increased scope for deductibility. The terms of engagement letters should therefore be worded carefully, potentially with separate instructions and invoices for non-transaction-related advice.

Centrica may still choose to appeal the decision to the Supreme Court and this would undoubtedly throw up some interesting questions.