

IV.A.3. Transaction Costs

Introduction Transaction costs are important in tax shelter cases.

Importance of Transaction Costs Courts consider transaction costs important in determining whether a transaction has economic substance.

ASA Investering Partnership v. Commissioner, 201 F.3d 505, 516 (D.C. Cir. 2000), aff'g T.C. Memo. 1998-305 ("There is no reason to believe that the taxpayer could not have realized ... [the taxpayer's business goals]... without the partnership at far, far lower transaction costs.")

ACM v. Commissioner, T.C. Memo. 1997-115 ("A rational relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the nontax benefits would be at least commensurate with the transaction costs." citing Yosha v. Commissioner, 861 F.2d 494, 498 (7th Cir. 1988), aff'd in relevant part 157 F.3d 231 (3rd Cir. 1998).

"[D]eliberately to incur an expense greater than the expected gain -- to pay 4 percent for the chance to make 2 percent -- is the antithesis of profit-motivated behavior; such a transaction lacks economic substance." Yosha, 861 F.2d at 498.

Saba Partnership v. Commissioner, T.C. Memo. 1999-359, vacated and remanded by, 273 F.3d 1135 (D.C. Cir. 2001); Seykota v. Commissioner, T.C. Memo. 1991-234, modified by T.C. Memo. 1991-541.

The Treasury White Paper, 1999 TNT 127-12 (released on July 1, 1999) considers high transaction costs an attribute of a corporate tax shelter.

Continued on next page

IV.A.3. Transaction Costs, Continued

Types of Transaction Costs

Types of Transaction Costs include:

- Investment banking or promoter fees. These fees can have many different labels, including but not limited to the following:
 - Investment banker fees
 - Engagement fees
 - Consulting fees
 - Commissions
 - Advisory fees
 - Contingent fees
 - Placement fees
 - Finders fees
 - Structuring fees
 - Origination fees
 - Brokerage fees
 - Spreads (bid-ask spreads) on financial instruments

- Payments to third parties. Often payments are made directly or indirectly as guarantees or inducements to participate in the transaction.

- Other Professional Fees
 - Accounting fees
 - Attorney fees

- Hidden fees. Sometimes fees or costs are embedded in financial instruments, characterized as part of another transaction, or paid in the guise of a broad, vague "consulting agreement." In such cases, significant fact finding is required.

Continued on next page

**Factual
Development**

Factual development regarding transaction costs

- Issue IDRs asking the taxpayer to identify all transaction costs associated with the transaction under audit. Make sure to request the transaction costs relating to all steps or parts of the transaction and all of the financial instruments used in the transaction for all years of the transaction. Transaction costs are usually paid over time and can be subject to contingencies.
- The following documents should be requested from the taxpayer:
 - All general ledger entries relating to the transaction, including entries related to all transaction costs.
 - Bills, invoices, agreements, and contracts related to transaction costs.
 - Canceled checks or wire transfer instruments evidencing all transfers of funds between or among participants in the transaction.
 - All estimates or projections of transaction costs given to or made by the taxpayer.
 - The taxpayer's explanation of the transaction provided to its accounting firm and the firm's workpapers recording the fees and costs of the transaction, including any documents discussing the financial accounting implications for the taxpayer.
- In addition, the taxpayer should be asked the following questions.
 - Were the fees contingent on any aspect of the transaction, including realization of the tax benefits?
 - How were the fees determined? Based on tax benefits?
 - What steps did the taxpayer take to investigate the amount and appropriateness of the transaction costs? Did the taxpayer compare the costs to costs of alternative transactions or transactions structured by another promoter?
 - How did the taxpayer treat the transaction costs for tax purposes? (deduct, capitalize, in what years?)

Continued on next page

IV.A.3. Transaction Costs, Continued

Disallowance of Transaction Costs

- Generally, the Service argues that fees, expenses and other transaction costs incurred in the hope of obtaining unwarranted tax benefits are not recognized as deductible losses or expenses. See Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 292-94 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001); Kirchman v. Commissioner, 862 F.2d 1486, 1490 (11th Cir. 1989) (stating expenses incurred in furtherance of a sham transaction are not deductible), aff'g Glass v. Commissioner, 87 T.C. 1087, 1177 (1986); Brown v. Commissioner, 85 T.C. 968 (1985), aff'd. sub nom. Sochin v. Commissioner, 843 F.2d 351 (9th Cir. 1988); United Parcel Serv. of Am., Inc. v. Commissioner, T.C. Memo. 1999-268.
 - Where costs are separable from the sham aspects of the transaction, fees may be allowable. ACM Partnership, 157 F.3d at 262-263 (permitting the deduction of taxpayer's economic loss); Saba Partnership, T.C. Memo. 1999-359 at 163-164 (disallowing legal fees related to the sham aspects of the transaction and allowing other unrelated fees).
-