NewsAlert

Tax Accounting Services

Tax Management and Accounting Services

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Accounting implications of recent IRS guidance on success-based fees

In summary

- IRS Revenue Procedure 2011-29, published April 8, 2011, provides a prospective safe-harbor election
- IRS examination directive, issued July 28, 2011, addresses the treatment of positions taken in prior years
- Companies that have incurred success-based fees in M&A transactions should assess the implications of this guidance on uncertain tax positions

Background

On April 8, 2011, the IRS released Revenue Procedure 2011-29, providing a safe-harbor election for taxpayers to allocate success-based fees, which are fees that are contingent on the successful closing of a transaction, between facilitative and non-facilitative amounts for covered transactions. In general, covered transactions are business acquisitions and certain reorganizations. Facilitative costs that are capitalized in a taxable asset transaction are generally treated as amortizable, whereas costs incurred in a stock transaction or reorganization are nonamortizable. The costs that are not considered to facilitate the transaction are treated as either currently deductible or amortizable, as applicable. Essentially the same principles apply to costs incurred by either party (e.g., acquirer, seller or target) to the transaction.

Under the safe-harbor, a taxpayer can irrevocably elect to treat 70 percent of all success-based fees incurred with respect to a covered transaction as non-facilitative. The remaining 30 percent is considered facilitative and must be capitalized. The Revenue Procedure is effective, and the election is available, for success-based fees paid or incurred in tax years ending on or after April 8, 2011.

On July 28, 2011, the IRS Large Business and International (LB&I) division issued a directive to LB&I examiners not to challenge a taxpayer's treatment of success-based fees paid or incurred in tax years ended *before* April 8, 2011, where the taxpayer's original return treatment

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was to capitalize at least 30 percent of the fees. The directive applies only for positions taken in original timely filed returns, and not for other claims, whether formal or informal.

The new guidance, although limited in scope, is expected to relieve an area of significant controversy between taxpayers and the IRS regarding the type and extent of documentation needed to substantiate these tax positions.

For more information on the provisions within Rev. Proc. 2011-29, please see PwC's Washington National Tax Services Insight, dated April 14, 2011, available via www.pwc.com.

Potential impact on uncertain tax positions

The potential impact of the Revenue Procedure and the LB&I directive should be considered in the assessment of a company's uncertain tax positions (UTPs) associated with success-based fees. As of each balance sheet date, uncertain positions must be assessed. Management must determine whether the amount of recognized tax benefits should be adjusted. ASC 740-10-25-14 requires that changes in the expected outcome of an uncertain position be based on new information, and not on a mere re-evaluation of existing information.

The following are illustrative fact patterns describing how a company might evaluate the effect of the IRS guidance on its UTPs. These examples are intended to highlight key aspects of the analysis. The conclusions should not be taken to exclude consideration of the specific facts and circumstances that apply to a company, which may result in different outcomes.

Example 1

Facts:

In 2009, Company A, a calendar year taxpayer, incurred success-based fees with respect to a covered transaction and completed an analysis to substantiate its allocation of the fees between facilitative and non-facilitative activities. Based upon the analysis, the Company took the position in its tax return that 40 percent of the fees are facilitative (and thus capitalizable) and the remainder considered non-facilitative. The Company recorded a liability for unrecognized tax benefits (UTBs) related to a portion of the fees that were treated as non-facilitative. An examination of the 2009 tax return, within LB&I, has begun but has not yet included any review of the success-based fees position. During Q2 2011, Company A concluded that Rev. Proc. 2011-29 did not result in a change in measurement of its UTPs.

Question:

Should Company A adjust its measurement of the tax benefit associated with the 2009 success-based fees in Q3 2011?

Answer:

Yes. The LB&I directive constitutes new information. In accordance with the LB&I directive, the IRS will not challenge the allocation of success-based fees paid or incurred in a covered transaction in tax years ended *before* April 8, 2011, where the taxpayer's original return treatment was to capitalize at least 30 percent of the fees. In the above fact pattern, Company A capitalized 40 percent of the total success-based fees, and therefore the tax position should

not be challenged. Accordingly, Company A would release its liability associated with the 2009 position.

Example 2

Facts:

The facts are the same as Example 1, except that Company A's tax return position claimed 90 percent of the success-based fees as non-facilitative.

Question:

Should Company A adjust its measurement of the tax benefit associated with the 2009 success-based fees in Q3 2011?

Answer:

No. The subsequent recognition of UTPs as a result of re-measurement should be based on management's best judgment given the facts, circumstances, and evaluation of new information. The LB&I directive does not appear to provide any protection to companies that have treated more than 70 percent of the fees as non-facilitative. Therefore, the taxpayer does not appear to have any new information upon which to base an adjustment to its UTP.

Example 3

Facts:

In 2009, Company A incurred success-based fees with respect to a covered transaction and completed an analysis to substantiate its allocation of the fees between facilitative and non-facilitative activities. Based upon the analysis, the Company determined that 50 percent of the fees were facilitative and should be capitalized and treated the remainder as non-facilitative in the original 2009 tax return. During Q2 2011, Company A concluded that Rev. Proc. 2011-29 did not result in a change in measurement of its UTPs. As a result of the IRS guidance, in Q3 2011, the Company amends its 2009 tax return to treat an additional 20 percent of the fees as non-facilitative.

Question:

Should Company A adjust its measurement of the tax benefit associated with the 2009 success-based fees in Q3 2011?

Answer:

No. The LB&I directive is only applicable if the requirements were met in originally filed tax returns. LB&I examiners are still expected to challenge the allocation of success-based fees between facilitative and non-facilitative in an amended return. In the absence of other information supporting the benefits claimed in the amended return, there would be no basis for recognizing those benefits.

Example 4

Facts:

Company A incurred success-based fees with respect to a covered transaction during June and July of 2011. The Company has decided to not make the safe-harbor election provided by Rev. Proc. 2011-29.

Question:
In measuring the UTP associated with the success-based fees, should Company A assume that based upon the Revenue Procedure 70 percent of the total success-based fees is the largest tax benefit that is greater than 50 percent likely of being realized upon settlement with the IRS?

Answer:
No. Taxpayers that choose to forgo the election must continue to gather supporting records to document the allocation. Taxpayers can expect to encounter at least the historical level of controversy with the IRS regarding the type and extent of documentation needed to substantiate an allocation of success-based fees between facilitative and non-facilitative activities. Therefore, measurement of the UTP should be based on management's best judgment in relation to the facts and circumstances.

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