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WNTS Insight

IRS seeks to minimize documentation controversy with safe-harbor election for success-based fees

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The IRS on April 8 released Rev. Proc. 2011-29, which creates a safe-harbor election for taxpayers seeking to allocate success-based fees between facilitative and non-facilitative amounts for "covered transactions" described in Reg. sec.1.263(a)-5(e)(3). In lieu of requiring the documentation specified in Reg. sec. 1.263(a)-5(f) to support the allocation of these transaction costs, the new safe harbor allows a taxpayer to use a simplified, percentage-based allocation for determining which portion of success-based transaction costs must be capitalized because they facilitate the transaction and which portion may be treated as not facilitating the transaction. 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 such an allocation.

Background

Reg. sec. 1.263(a)-5 generally provides that a taxpayer must capitalize amounts paid to facilitate certain transactions enumerated in Reg. sec. 1.263(a)-5(a). An exception to the general rule provides that for certain acquisitive "covered transactions" described in Reg. sec. 1.263(a)-5(e), a portion of the transaction costs may be treated as not facilitating the transaction. The costs that are not considered to facilitate the transaction do not need to be capitalized and are treated as either currently deductible or amortizable, as applicable.

Pursuant to Reg. sec. 1.263(a)-5(f), success-based fees incurred upon the consummation of a covered transaction are presumed to be facilitative unless allocated to non-facilitative activities, with any such allocation supported by contemporaneous documentation. A success-based fee is defined in Reg. sec. 1.263(a)-5(f) as "an amount paid that is contingent on the successful closing of a transaction…."

The taxpayer is responsible for proving that a portion of the success-based fee was non-facilitative if it does not wish to capitalize the full amount of the fee. Reg. sec. 1.263(a)-5(f) describes the documentation necessary for a taxpayer to substantiate its allocation of a success-based fee between the portion that facilitates and the portion that does not facilitate a covered transaction. The documentation must consist of

supporting records that can include time sheets, invoices, or other records, and must contain the four elements set forth in the regulation. In addition, all documentation must be completed before the due date (including extensions) of the taxpayer's federal income tax return for the year in which the transaction was completed.

The adequacy of documentation gathered by taxpayers to support an allocation of success-based fees has been the source of considerable controversy between taxpayers and IRS examining agents. The IRS stated in Rev. Proc. 2011-29 that "numerous disagreements have arisen regarding the type and extent of documentation required to establish that a portion of a success-based fee is allocable to activities that do not facilitate a business acquisition or reorganization transaction" and that the government expects much of this controversy can be eliminated through the safe harbor.

New Guidance

Rev. Proc. 2011-29 provides a safe harbor that taxpayers can use to provide certainty in allocating success-based fees associated with a covered transaction between facilitative and non-facilitative activities. Under the safe harbor, a taxpayer can elect to treat 70 percent of all success-based fees incurred with respect to a particular transaction as non-facilitative. The remaining 30 percent is considered facilitative and must be capitalized.

Observations: It remains unclear how taxpayers that elect to apply the safe harbor are to differentiate between routine, ongoing financial advisory services unrelated to a specific transaction, which would be currently deductible under section 162, from the investigatory due diligence activities that may be subject to amortization as start-up expenditures under section 195. In light of this uncertainty, it seems that some documentary support still could be necessary in that situation. Similarly, if a financial advisor assisted with obtaining financing for a transaction, some portion of the success-based fee would seem to be allocable to the borrowing transaction and amortized under Reg. sec. 1.446-5. In addition, services rendered in connection with abandoned transactions presumably would require further documentation to accommodate the "mutually exclusive" test under Reg. sec. 1.263(a)-

5(c)(8), but this is yet another unknown. Whether these concerns might impact the 70-percent allocation and ultimately require taxpayers to continue to maintain some level of documentation remains to be seen.

The safe-harbor method described in the revenue procedure applies only to covered transactions listed in Reg. sec. 1.263(a)-5(e)(3), which are:

- A taxable acquisition of assets that constitute a trade or business,
- A taxable acquisition of ownership interest in which the acquirer and target are related within the meaning of section 267(b) or section 707(b) immediately afterwards, and
- A reorganization described in sections 368(a)(1)(A), (B), (C), or (D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under section 354 or section 356.

Observations: Before a taxpayer evaluates whether it would be beneficial to elect the safe harbor provided in Rev. Proc. 2011-29 with respect to a particular transaction, the taxpayer first must determine whether the transaction is a covered transaction as outlined in Reg. sec. 1.263(a)-5(e)(3) and if so, whether a particular fee is a success-based fee.

To elect the safe harbor, a taxpayer must attach a statement to its original federal income tax return for the tax year in which the success-based fee is paid or incurred. The statement must identify the transaction and the amounts that are being capitalized and deducted. The election, which is irrevocable, can be made on a transaction-by-transaction basis. ***Note:*** The revenue procedure specifically provides that the safe-harbor election does not constitute a change in method of accounting for success-based fees generally, so there is no adjustment under section 481.

Observations: Taxpayers that believe they can support an allocation of more than 70 percent of success-based fees to non-facilitative

categories may choose to forego the election and continue to gather supporting records to document the allocation. However, taxpayers should anticipate encountering 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 transaction costs between facilitative and non-facilitative activities. Taxpayers that incur success-based fees with respect to non-covered transactions enumerated in Reg. sec. 1.263(a)-5(a) still must document an allocation of success-based fees to non-facilitative activities (for example, to transactions that were considered but abandoned). In that regard, the revenue procedure does not provide any additional guidance to taxpayers with respect to the documentation requirements for success-based fees when the taxpayer does not elect the safe harbor or in instances when the safe harbor does not apply.

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.

Observation: Although Rev. Proc. 2011-29 applies prospectively for success-based fees paid or incurred in tax years ending on or after April 8, 2011, the extent to which, if at all, IRS exam and Appeals may defer to a 70-percent allocation as a means of resolving pending transaction cost controversies remains uncertain.

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