PLUS renew your subscription with the e version by December 1, 2011, and we will cut the price by 10%!
Call 800-248-3248 to renew and save!

The M&A Tax Report

NOVEMBER 2011 VOLUME 20, NUMBER 4

The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF

Robert W. Wood
Wood LLP
San Francisco

ASSISTANT EDITOR

Larry Suh
Wood LLP
San Francisco

ADVISORY BOARD

Jonathan R. Flora
Schnader Harrison Segal & Lewis
Philadelphia

Steven R. Franklin
Gunderson Dettmer
Menlo Park

Lawrence B. Gibbs
Miller & Chevalier
Washington

Ivan Humphreys
Wilson Sonsini Goodrich & Rosati
Palo Alto

Steven K. Matthias
Deloitte & Touche
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate, Meagher & Flom
New York

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Robert Willens, LLC
New York

Tax Treatment of M&A Success Fees

By Robert W. Wood • Wood LLP

How do you measure success? A recent IRS position might suggest that 70 percent could be the right number. Companies often pay a success fee, hinging on the successful closing of a transaction. But after the high-fives and other accolades have died down, someone needs to consider the tax treatment.

The age-old question is whether to deduct or capitalize. Those battle lines are well-drawn and have rather predictable positions by taxpayers and the IRS. However, some of that may be changing. Indeed, recent suggestions are that 70 percent of a success fee may be deductible, a pretty good number when you think about the alternatives.

LB&I Directive

The IRS's Large Business & International Division (LB&I) has stated that its examiners should not challenge success-based fees paid or incurred in acquisitions or reorganizations in tax years ending before April 8, 2011, as long as the taxpayer capitalized at least 30 percent. That is, taxpayers who originally capitalized at least 30 percent of success fees are given a free pass. Those numbers correspond to the safe harbor provided in Rev. Proc. 2011-29, IRB 2011-18, 746. The LB&I Directive can be viewed at *www.irs.gov/businesses/article/0,,id=243612,00.html.*

Internal Revenue Code Section ("Code Sec.") 263(a)(1) provides that taxpayers cannot claim a deduction for amounts paid for property having a useful life substantially beyond the tax year. In the context of business acquisitions and reorganizations, costs that produce significant long-term benefits must be capitalized. The regulations make this explicit. Reg. §1.263(a)-5 states that amounts paid to facilitate a business acquisition or reorganization must be capitalized.

Among the covered costs subjected to this treatment are costs paid in the process of investigating or otherwise pursuing the transaction. One of the classic costs of pursuing the deal is a success

ALSO IN THIS ISSUE

or success-based fee, traditionally paid on a successful closing. Thus, a "success-based fee" is presumed to be an amount paid to facilitate the transaction.

Taxpayers can rebut this presumption, but that requires proof. Taxpayers should maintain sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. Talk about proving a negative. But fortunately, some of that proving a negative appears no longer to be necessary.

In Rev. Proc. 2011-29, the IRS enunciated a safe harbor for allocating success-based fees. Covered fees are those specifically paid or incurred in transactions described in Reg. §1.263(a)-5(e)(3). This revenue procedure only applies to success-based fees that are paid or incurred in years ended on or after April 8, 2011.

But the benefits are a poor record-keeper's delight. Rather than painstakingly maintaining the documentation required by Reg. §1.263(a)-5(e)(3), the revenue procedure allows one to make an election to treat 70 percent of the success-based fees as an amount that does not facilitate the transaction. Of course, the corollary is that 30 percent of the fee must be capitalized. By anyone's measure, that is not a bad deal.

An election under the revenue procedure will apply only to the transaction for which the election is made. Moreover, once made, such an election is irrevocable. The election applies with respect to all success-based fees that are part of the transaction for which the election is made. Put differently, you make the election for an entire transaction.

Mechanics

The election requires a statement attached to the taxpayer's original return for the year in which the success-based fee is paid or incurred. The attachment must state that it is electing the safe harbor, identify the transaction to which the election relates and state the success-based fee amounts that are deducted and capitalized, reflecting the 70/30 split.

Whether this represents the IRS's view of the right result, what might be rough justice or a simple allocation of personal and resources is not clear. Yet there are some indications that the primary impetus for this move may simply be a balancing of recourse. Whatever the impetus, though, in all but the largest transactions, where the sheer dollars involved might make the 30-percent number a very large one, this provides certainty and is a pretty good deal. Avoiding the gyrations of recording what does and what does not facilitate the deal can be a blessing.

If there was any doubt about the need to have the 70/30 election made on an original (and timely filed) return, the Directive makes that point eminently clear. This is not a deal one can get on an amended return or during the course of an audit. Similarly, one cannot take advantage of this deal in a refund claim.

Conclusion

Success-based fees are useful, and are driven by economics. They can make deals happen. Perhaps more accurately (and with less hyperbole), success-based fees can at least help

The M&A Tax Report
The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Farley

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.
©2011 CCH. All Rights Reserved.

Permissions requests: Requests for permission to reproduce content should be directed to CCH, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.

CCH Journals and Newsletters
Email Alert for the Current Issue
Sign Up Here... CCHGroup.com/Email/Journals

contribute to the *environment* in which the deals happen. However, once the money is paid and tax return time starts to approach, someone will need to start worrying about whether and how much to capitalize. Rev. Proc. 2011-29 and the LB&I Directive replicating its split can save many tax professionals worry, uncertainty, time and money.