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New IRS Compliance Campaign Spotlights Deduction of Success-Based Fees

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Companies paying success-based fees to advisers on capital transactions should exercise caution when deducting rather than capitalizing the expenses. The capitalization rules, a safe harbor election, documentation requirements, and increased scrutiny of success-based fee deductions complicate the analysis.

On September 14, 2020, the Large Business and International ("LB&I") division of the Internal Revenue Service (the "**IRS**") announced a new compliance campaign focusing on the allocation of success-based fees "Without Rev. Proc. 2011-29."

In many M&A transactions, a large percentage of the fees charged by advisors for their work on the transaction is contingent on the successful closing of the transaction. The section 263(a) regulations[1] require taxpayers to capitalize these costs into the transactions on which the costs are contingent, unless stringent documentation requirements are satisfied to support a taxpayer's allocation of a portion of the fee to deductible activities.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

Disputes between taxpayers and the IRS led the IRS to issue Revenue Procedure 2011-29, which permits taxpayers to elect to capitalize only 30 percent of fees that are contingent on the consummation of transactions described by section 1.263(a)-5(e)(3) ("**Covered Transactions").** Notwithstanding the issuance of this revenue procedure, taxpayers and the IRS continue to disagree about the application of the documentation requirements of section 1.263(a)-5(f). The new compliance campaign is an indication that this will be an area of increased focus on examination.[2]

This article briefly describes the capitalization rules applicable to success-based fees, including the documentation requirement that has been the subject of conflict between taxpayers and the IRS. While this has been an area of ongoing concern, taxpayers may want to bring renewed focus to their documentation of success-based fees in light of the new compliance campaign.

Background and Analysis

Basic Capitalization Rules for Capital Transactions

Section 1.263(a)-5 requires taxpayers to capitalize amounts paid to "facilitate" certain defined transactions (that we refer to as "**Capital Transactions**"), such as the acquisition of a majority interest in a business entity.[3] An amount is paid to facilitate a transaction when it is paid in the process of investigating or otherwise pursuing the transaction.[4] The determination of whether an expense is paid in the process of investigating or otherwise pursuing a transaction is based on all facts and circumstances. Moreover, the regulations provide that the fact that an amount would not have been paid but for the transaction is not determinative to being treated as facilitating the transaction.

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[2] This compliance campaign follows the announcement on March 14, 2018, that the IRS was opening a compliance campaign relating to costs that facilitate section 355 transactions. The announcement indicates that the IRS was concerned that taxpayers who execute a corporate distribution may have been improperly deducting the costs that facilitated the transaction in the year the distribution was completed. However, we are not aware of any indication that this campaign has led to an increase in audit activity on the issue thus far.

[3] More fully, section 1.263(a)-5(a) requires taxpayers to capitalized costs incurred to facilitate: (1) an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition); (2) an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b) or 707(b) (see section 1.263(a)-4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, or to facilitate the acquisition of an ownership interest in a business entity, when the taxpayer and the business entity are not related within the meaning of section 267(b) or 707(b) immediately after the acquisition); (3) an acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise); (4) a restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in section 368 and distributions of stock by the taxpayer as described in section 355); (5) a transfer described in section 351 or section 721 (whether the taxpayer is the transferor or transferee); (6) a formation or organization of a disregarded entity; (7) an acquisition of capital; (8) a stock issuance; (9) a borrowing (for purposes of this section, a borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization; a borrowing also includes debt issued in a debt for debt exchange under section 1.1001-3); and (10) writing an option.

[4] Section 1.263(a)-5(b)(1).

While the definition of facilitation is broad, the regulations distinguish between operational and transaction costs. For example, a taxpayer is not required to capitalize costs incurred to operate its business notwithstanding that it may incur these costs while undertaking a Capital Transaction.[5] Further, a taxpayer is not required to capitalize the costs of "re-engineering" its business operations, described in the preamble to the proposed regulations as "mere changes in an entity's business processes."[6]

More specifically, a taxpayer is not required to capitalize costs to integrate the target business with the acquiring business, even though the costs would not have been incurred but for the acquisitive transaction.[7] The regulations also provide simplifying conventions: The taxpayer's overhead and employee compensation generally will not facilitate a Capital Transaction, notwithstanding that the costs would not have been incurred but for the transaction.[8]

Moreover, a taxpayer is subject to more generous capitalization rules for costs incurred to facilitate Covered Transactions described by section 1.263(a)-5(e)(3).[9] Specifically, a taxpayer is required to capitalize costs incurred to facilitate a Covered Transaction only if the costs are (1) incurred on or after a certain date (the "**Bright-Line Date**"); or (2) described in an exclusive list of "inherently facilitative" activities ("**Inherently Facilitative Costs**"), regardless of when occurred.[10] Pre-Bright Line Date non-

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[5] *See, e.g.*, section 1.263(a)-5(c)(4) ("[A]mounts specifically paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization under Chapter 11 that resolves tort liabilities of the taxpayer do not facilitate a reorganization within the meaning of paragraph (a)(4) of this section if the amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. . . . An amount paid by the debtor to operate its business during a Chapter 11 bankruptcy proceeding is not an amount paid to institute or administer the bankruptcy proceeding and does not facilitate a reorganization. Such amount is treated in the same manner as it would have been treated had the bankruptcy proceeding not been instituted.").

[6] 67 Fed. Reg. 77701, 77705 (Dec. 19, 2002) ("The terms reorganization and restructuring are not intended to refer to mere changes in an entity's business processes, commonly referred to as "re-engineering."); section 1.263(a)-4(l), *Example 5* (business process re-engineering costs do not create an intangible).

[7] Section 1.263(a)-5(c)(6).

[8] Section 1.263(a)-5(d).

[9] Section 1.263(a)-5(e)(3) exclusively defines Covered Transactions as the following transactions: (1) a taxable acquisition by the taxpayer of assets that constitute a trade or business; (2) a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b); and (3) a reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

[10] Section 1.263(a)-5(e)(1). The bright line date is the earlier of when a letter of intent, exclusivity agreement, or similar written communication is executed or when the material terms of the transaction are agreed to by the taxpayer's board of directors or other appropriate governing officials. *Id.* The expenditures considered inherently facilitative are listed in section 1.263(a)-5(e)(2) as: (1) securing an appraisal, formal written evaluation, or fairness opinion related to the transaction; (2) structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (for example, obtaining tax advice on the application of section 368); (3) preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement); (4) obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings; (5) obtaining shareholder approval of the transaction (for

Inherently Facilitative Costs not required to be capitalized may be deducted under section 162 to the extent that the taxpayer already is viewed as engaging in a business or otherwise may be amortizable over 15 years pursuant to section 195. As a practical matter, much of the pre-Bright Line Date non-Inherently Facilitative costs tend to be for due diligence on the Covered Transaction.

Success-Based Fees

Generally, investment bankers and, occasionally, lawyers will charge their clients success-based fees payable only in the event that the transaction is consummated. Section 1.263(a)-5(f) provides a rebuttable presumption that, fees contingent on the successful close of a transaction listed in section 1.263(a)-5(a) facilitate the transaction. However, a taxpayer can rebut the presumption by demonstrating that portions of the fee are allocable to activities that do not facilitate the transaction. To support such an allocation, the regulations require the taxpayer to maintain documentation sufficient to establish the portion of the service provider's time that was spent on the non-facilitative activities. This documentation must be completed on or before the due date for the taxpayer's timely filed original federal income tax return (including extensions) for the tax year during which the transaction closes.

Section 1.263(a)-5(f) also specifies that the required documentation must show more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction. Rather, the documentation must consist of supporting records (for example, time records, itemized invoices, or other records) that identify:

- The various activities performed by the service provider;
- The amount of the fee (or percentage of time) that is allocable to each of the various activities performed;
- If the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, then the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and
- The name, business address, and business telephone number of the service provider.

Therefore, the regulations generally require taxpayers to capitalize costs payable only on the consummation of a Capital Transaction, putting the onus on the taxpayer to document any allocation of a portion of that fee to deductible activities.

Because there are few standards describing the necessary sufficiency of this documentation, assessing the adequacy of a taxpayer's documentation is difficult and time consuming on examination. The documentation issue has historically resulted in significant conflict between taxpayers and the IRS. While several administrative rulings issued by the IRS give some insight regarding the government's

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example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or (6) conveying property between the parties to the transaction (for example, transfer taxes and title registration costs).

thinking about the applicable standard for documentation, they generally decline to reach a conclusion on the issue.[11] The rulings include the following:

TAM 201002036 (September 21, 2009). The taxpayer paid a success-based fee to an investment bank in connection with the acquisition of the taxpayer. The investment bank's invoice did not contain any detailed breakdown of the services and the investment bank did not produce any time reports for the services performed. The taxpayer engaged an accounting firm to perform a transaction cost study. The accounting firm interviewed the employees of the investment bank who had worked on the transaction and prepared a spreadsheet that outlined the percentage of the investment bank's time that was spent on each activity, including the amount of time spent before the bright-line date. The taxpayer also provided the IRS with significant additional documentary support in the form of the investment bank's work product and employee notes to help in establishing the amount of work performed by the investment bank on non-facilitative activities. The advice given by the Office of Chief Counsel in the TAM is that the documentation provided by the taxpayer should be viewed as "other records" that may support the taxpayer's allocation, but that whether these "other records" were sufficient to support the taxpayer's deduction was a factual determination that must be made by the examination team.

PLR 200953014 (September 15, 2009). The taxpayer was acquired in a merger transaction and requested several rulings relating to the transaction costs associated with the transaction. The taxpayer incurred fees from various service providers, including success-based fees. With respect to its success-based fees, the taxpayer requested a ruling regarding the kinds of documentation that the taxpayer could rely on in determining whether any portion of the fee was deductible. The taxpayer intended to look to: service provider invoices, service provider attestation regarding the scope and timing of services, service provider engagement letters, board of director minutes, corporate and service provider meeting minutes and calendar entries, documents developed by the providers and presented to the board of directors, general ledger entries, financial statements, management agreement, flow of funds memo, wire transfer and other bank records, transaction documents, and the taxpayer's internal accounting information. The ruling states that the regulations do not specifically require time records to support an allocation of a success-based fee, and that courts have considered many different kinds of documentary support, even if the allocation that results is "less scientific." The ruling concludes that the taxpayer should evaluate all available evidence to determine the proper allocation.

PLR 200830009 (April 11, 2008). The taxpayer was acquired in a merger transaction and sought guidance on whether it could allocate lump sum payments it made to service providers between different categories of activities. With respect to its success-based fees, the taxpayer stated that no detailed billing records were available. The ruling confirms that time records are not a requirement under the regulations, and that other records can be used to support an allocation of success-based

[11] Written determinations such as private letter rulings ("PLRs") and technical advice memoranda ("TAMs") represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and these types of written determinations are not intended to be relied on by third parties and may not be cited as precedent. Section 6110(k). They do, however, provide an indication of the IRS's position on the issues addressed.

fees. However, the ruling states that the determination of whether the taxpayer's records are sufficient to support an allocation is a factual question for examination.

While administrative rulings cannot be relied on as authority, they can be useful as an indication of the IRS's administrative practice in a particular area.[12] These rulings indicate that a large amount of uncertainty remains about the IRS's view of the necessary sufficiency of the documentation to support the allocation of a success-based fee. Nevertheless, the rulings are helpful in indicating that the IRS believes that time records are not specifically required under section 1.263(a)-5(f). However, none of the rulings actually conclude on whether the particular taxpayer actually satisfied the documentation requirement. As such, they are unable to paint a particularly clear picture of the IRS's view, and further highlight the need for additional guidance on the issue.

To reduce the conflict caused by the documentation issue, the IRS created a success-based fee safe harbor in Revenue Procedure 2011-29.[13] In the case of a Covered Transaction, Revenue Procedure 2011-29 allows a taxpayer to elect to treat 70 percent of the success-based fee as an amount that does not facilitate the transaction.[14] The remaining 30 percent of the success-based fee is therefore considered to facilitate the Covered Transaction, and is capitalized. By electing the safe harbor, a taxpayer gains certainty on the issue and can take the documentation question off the table during an examination.

Despite what is generally a very favorable safe harbor, it is not uncommon for taxpayers who undertake Covered Transactions to determine that greater than 70 percent of the success-based fees paid to an advisor actually relate to due diligence performed prior to their Bright-Line Date, meaning that the taxpayers could be entitled to a larger deduction than allowed under Revenue Procedure 2011-29. In these cases, the taxpayer must weigh the certainty of the safe harbor against the strength of its ability to document a larger deduction.

An Ongoing Area of Tension

While the IRS attempted to effectively eliminate the documentation issue for most large Capital Transactions by providing a generous safe harbor, the announcement of a new compliance campaign demonstrates that the issue is far from dead. When the safe harbor is either not available[15] or is simply not elected, there remains the possibility of a taxpayer's documentation being challenged. Also, while the IRS describes the compliance campaign as focusing on the treatment of fees "Without Rev. Proc. 2011-29," it doesn't specify a transaction in which an election was not made. For example, the campaign also could apply to allocation issues when the taxpayer has elected the revenue procedure and the transaction on which the payment of the fee is contingent has both a Covered Transaction component (to which the election would apply) and a non-Covered Transaction component (to which

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[12] Section 6110(k)(3); *see, e.g.*, Bunney v. Commissioner, 114 T.C. 259, 261 n.2 (2000).

[13] 2011-18 I.R.B. 746.

[14] The taxpayer must attach a statement to its original federal income tax return for the year that the fees were paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted and capitalized. The election is irrevocable.

[15] For example, where the taxpayer's transaction is not a Covered Transaction eligible for Revenue Procedure 2011-29.

the election would not apply), most frequently a borrowing. In that situation, notwithstanding the election, the taxpayer still must allocate the success-based fee between the Covered Transaction portion and the non-Covered Transaction portion of the overall transaction, raising questions about the sufficiency of documentation.[16]

Although a taxpayer is sometimes unable to make a Revenue Procedure 2011-29 election, a taxpayer that engages in a Covered Transaction and chooses to venture beyond the protection of the safe harbor may be exposing itself to avoidable peril. For example, the IRS strongly stated its position in a 2018 Chief Counsel Advisory (the "**CCA**").[17] The taxpayer subject to the CCA had engaged an investment bank to help it explore a possible sale, in exchange for a percentage of the sale price paid in a successful closing. The taxpayer declined to elect the Revenue Procedure 2011-29 safe harbor, and instead asked the investment bank to estimate how much time it spent on various activities relating to the transaction. The investment bank produced a two-page letter, stating that it could not provide detailed estimates based on the amount of time spent on certain aspects of the transaction because it did not keep time records. Instead, the investment bank provided the approximate percentages of time spent on different activities, estimating that it had spent 92 percent of its time on due diligence to locate a buyer. However, the letter also included a caveat from the investment bank that the numbers provided were merely estimates and shouldn't be relied on by the taxpayer.

Despite the caveat in the letter, the taxpayer relied on the investment bank's estimates and deducted 92 percent of the fee as being allocable to activities that did not facilitate the sale. When pressed on audit to produce additional documentation, the taxpayer only was able to produce a single PowerPoint presentation prepared by the investment bank that had been used to describe possible acquisition strategies to the taxpayer's board of directors. The IRS concluded that the letter from the investment bank was merely an allocation between activities, expressly rejected as sufficient documentation under section 1.263(a)-5(f). The IRS reasoned that, without supporting records to explain the allocation, the documentation requirement was not met. Moreover, while the PowerPoint demonstrated that the investment bank must have performed non-facilitative activities, it did not provide any documentation of how much of the fee would have related to those activities. Therefore, the IRS concluded that the taxpayer was not entitled to deduct *any* portion of the success-based fee.

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[16] For example, PLR 201808005 (Nov. 27, 2017) permitted a taxpayer to make a late Revenue Procedure 2011-29 election for a transaction fee to an advisor that was contingent on the closing of the purchase of a target company. The contingent fee related both to financing activities by the advisor (not a Covered Transaction), as well as the acquisition itself (a Covered Transaction). The taxpayer examined the invoices and other documentation to determine the portion of the fee that related to the Covered Transaction (and therefore eligible for the safe harbor under Revenue Procedure 2011-29) and the financing transaction (all of which would have been amortizable over the term of the borrowing). While the ruling caveats that it is not opining on whether the transaction was within the scope of the revenue procedure or "whether Taxpayer properly included the correct costs as its success-based fees subject to the retroactive election," it is instructive that the IRS appears to have found that such an allocation was appropriate. *See, e.g.*, PLR 201930020 (April 22, 2019) (taxpayer in 9100 ruling request allocated single success-based fee between a Covered Transaction merger (for which a Revenue Procedure 2011-29 election was made) and an acquisition that did not constitute a Covered Transaction).

[17] CCA 201830011 (July 27, 2018).

The result in the CCA was harsh, but it serves as a cautionary reminder that the documentation rules for taxpayers outside the safe harbor are strict and that the IRS takes the documentation rules very seriously.[18] While some comfort can be taken from the fact that the description of the documentation provided by taxpayer in the CCA to support its position was fairly anemic (one can picture the examining agent reading the letter and asking, "If the document says that the taxpayer cannot rely on it, why should I?"), nevertheless, the CCA suggests that a taxpayer should proceed with more than just an allocation letter from a banker. The announcement of a new compliance campaign in this area suggests that a significant number of taxpayers are not making the election for success-based fees and further heightens the tension on an already tense issue.

How KPMG Can Help

Given how common success-based fee arrangements are in the M&A space, any taxpayers contemplating large capital transactions should be aware of the IRS focus on compliance with the success-based fees rules. The KPMG transaction services team in M&A tax can help you understand and apply the capitalization rules relating to success-based fees and can assist you in determining whether electing the safe harbor in Revenue Procedure 2011-29 is the correct decision. In particular, a transaction cost study by the KPMG transaction services team can provide you with the best available information to use in making that decision. If you determine that electing the safe harbor is not advisable, or at least some portion of the transaction is not eligible for the safe harbor, the KPMG transaction services team can help you prepare documentation sufficient to support an allocation of a portion of the success-based fee to deductible activities by the service provider.

KPMG Contacts

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[18] LB&I's Process Unit Knowledge Base demonstrates that the IRS has emphasized educating its personnel on this issue. Chapter 3 of Book 225 of the Knowledge Base (updated Jun. 4, 2019) provides an in-depth outline of how field personnel should approach the issue and the relevant authorities to consider.