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IRS Provides Safe Harbor for Capitalization of Success-Based Fees

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On April 8, the Internal Revenue Service (the IRS) issued Revenue Procedure 2011-29,[1] which provides a beneficial safe harbor with respect to the often-disputed issue of the capitalization of success-based fees incurred for certain business acquisition or reorganization transactions.

Generally, under Treasury Regulations Section 1.263(a)-5, amounts paid by a taxpayer to "facilitate" certain types of acquisition or reorganization transactions—including the purchase of assets constituting a trade or business, many purchases of stock or other ownership interests in a business entity, restructurings or recapitalizations of the capital structure of a business entity, stock issuances, borrowings and the like[2]—must be capitalized by the taxpayer, rather than immediately deducted. In a typical sale of stock, this result usually means that large expenses incurred by the target company, such as investment banking expenses, do not result in deductible expenses. Amounts paid that do not "facilitate" a transaction need not be capitalized. Because the line between an expense that "facilitates" a transaction and one that does not is sometimes unclear and subject to debate, the issue of capitalization of facilitating expenses is one that has often caused disputes between the IRS and taxpayers.

These disputes have been particularly significant in the case of fees that are contingent on the successful closing of a transaction (called success-based fees). The regulations specify that a success-based fee is presumed to facilitate a transaction, unless a taxpayer can maintain and provide sufficient documentation to establish that a portion of the fee can be allocated to non-facilitating activities, which generally are the services provided before a "bright-line date" such as the date the parties enter into a letter of intent. Because of the relative size of some success-based fees incurred for acquisitive transactions, and the difficulty of determining what constitutes "sufficient documentation," taxpayers and the IRS have clashed frequently over this issue. Taxpayers have tried to provide "sufficient documentation" in many ways, such as providing information on the various strategic alternatives considered for each deal and on alternative abandoned deal structures, in an attempt to allocate a portion of the success-based fees incurred to these alternative structures and abandoned deals.

In Revenue Procedure 2011-29, the IRS recognized the ongoing controversy over success-based fees and concluded that a safe harbor would be helpful to eliminate many of the disputes. To this end, Revenue Procedure 2011-29 allows a taxpayer to elect to capitalize 30 percent of a success-based fee as an amount paid to facilitate certain covered transactions (namely taxable acquisitions of trades or businesses, taxable acquisitions of business entities, or tax-free reorganizations) while allowing the taxpayer to treat the remaining 70 percent as an amount paid that does not facilitate a transaction. For each transaction for which the safe harbor is elected, all success-based fees for such transaction must be subject to the 30 percent/70 percent allocation. The safe harbor election is made on a transaction-by-transaction basis, and thus, a taxpayer need not apply the safe harbor to all transactions in a particular year.

Revenue Procedure 2011-29 should greatly simplify the capitalization issues surrounding success-based fees, and should be a welcome relief to taxpayers incurring substantial success-based fees for covered transactions. The safe harbor has the potential to allow taxpayers substantial deductions for success-based fees while avoiding significant and costly disputes with the IRS over the proper allocation of such fees.

Taxpayers should still work to produce appropriate documentation substantiating the deductible portion of any success-based fees under Treasury Regulations Section 1.263(a)-5. For example, the target company should engage the investment bankers for the transaction and not the shareholders. Also, there may be opportunities to deduct more than the 70 percent set forth in the safe harbor if service providers produce detailed information of the services they have provided and when such services were provided.

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[1] See the attached link for a copy of Revenue Procedure 2011-29: http://www.irs.gov/pub/irs-drop/rp-11-29.pdf.
[2] Treasury Regulations Section 1.263(a)-5 generally does not apply to amounts paid as brokerage commissions incurred in most real estate purchase and sale transactions or leasing transactions.

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