

Tax Deductions for Transaction Costs: IRS Update and Practical Guide To Supporting a Deduction

Tax Executive Institute
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October 18, 2018

Agenda

- ▶ Discuss Framework for Reviewing the Proper Tax Treatment of “Transaction Costs” and “Origin of the Claim” doctrine.
- ▶ Review Treas. Reg. Section 1.263(a)-5.
- ▶ What is “ordinary and necessary” in the context of a transaction to support a deduction under Section 162
- ▶ Information Needed to Perform an Allocation.
- ▶ Differences in Transaction Cost Treatment for Stock Acquisitions and Asset Acquisitions
- ▶ Identify the factors present in an analysis of the “Direct and Proximate Benefit” Test and which party should take costs into account
- ▶ Success based fees, Rev. Proc. 2011-29 safe harbor election, and 9100 Relief

“Origin of the Claim” Doctrine

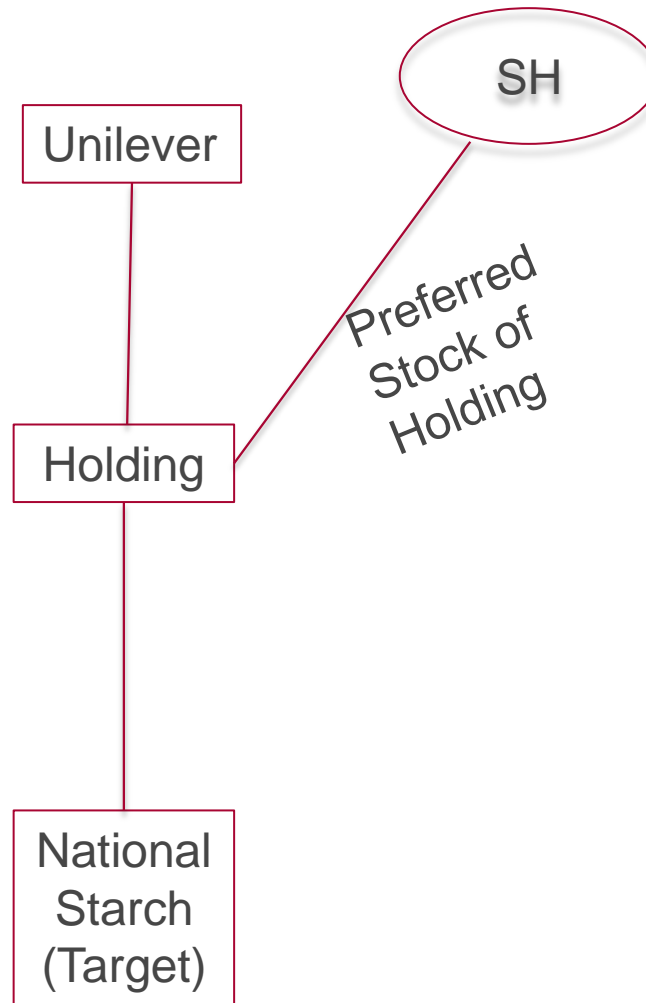
- ▶ Doctrine arose in cases deciding whether a cost was a business expense or a personal expense
- ▶ United States v. Gilmore, 372 U.S. 39 (1963)
 - Availability of a deduction for an expense depends on whether the expense item itself is one that has a “business origin.” *Id.* at 45.
 - A business expense will be deductible if it arises in connection with the taxpayer’s profit seeking activities. *Id.* at 48.
- ▶ Determine what services were performed and what such services related to, i.e., revising employee compensation plans, negotiating debt agreements, drafting acquisition agreements, revising license agreements, preparing fairness opinion, roadshow to identify and meet with investors, etc.

Indopco v. Commissioner, 503 U.S. 79 (1992)

- ▶ In the Tax Court and Third Circuit, the taxpayer was National Starch. (They changed their name to INDOPCO).
- ▶ As part of the transaction two new entities were created, National Starch and Chemical Holding Corp. (HOLDING), a subsidiary of Unilever, and NSC Merger, Inc. (NSC Merger), a subsidiary of HOLDING that was a transitory entity.

Indopco v. Commissioner

Structure after transaction completed.



Indopco v. Commissioner

- ▶ Transaction fees at issue were paid by National Starch (Target)
 - Morgan Stanley - \$2,200,000 + expenses
 - Debevoise - \$490,000
 - Accounting & other costs - \$150,962

Indopco v. Commissioner

▶ History of Court Decisions

- On Target's short tax year return that ended on the date of the transaction, it deducted \$2,225,586 paid to Morgan Stanley but did not deduct the Debevoise fee, accounting fee or other costs
- Tax Court denied deductions and said they were capital in nature and produced "long-term benefits"
- Third Circuit Court of Appeals affirmed Tax Court, saying that the resources of Unilever and synergies created as a result of the transaction would provide long-term benefits to National Starch's business
- U.S. Supreme Court affirmed the Court of Appeals

Indopco v. Commissioner

▶ History of Court Decisions

- The taxpayer argued that Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971), changed the rules with respect to capitalization of costs and required that capitalization occurred if the costs create or enhance an identifiable asset. INDOPCO, 503 U.S. at 83.
- The Supreme Court “noted the ‘familiar rule’ that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer” citing Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943); Deputy v. DuPont, 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). INDOPCO, 503 U.S. at 85.
- “Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization.” Id.

Indopco v. Commissioner

- ▶ Factors allowing for deductibility of an expense
 - Paid or incurred during the taxable year,
 - Be for carrying on a trade or business,
 - Be an expense,
 - Be a necessary expense, and
 - Be an ordinary expense. *INDOPCO*, 503 U.S. at 85, citing *Lincoln Savings*, 403 U.S. at 352
- ▶ Each case depends on its own facts

Can Capitalized Transaction Costs be Recovered?

- ▶ Certain cases address the recovery of previously capitalized costs.
- ▶ We infer from the INDOPCO and other cases that capitalized transaction costs somehow go on the books of the company when the transaction closes.
- ▶ Once a liquidation or other sale event occurs an analysis of whether or not the previously capitalized costs can be deducted needs to be reviewed and documented.
- ▶ Treas. Reg. § 1.263(a)-5(g) – describes the treatment of certain capitalized costs.

McCrory v. United States, 651 F.2d 828 (2d Cir. 1981)

- ▶ In *McCrory v. U.S.*, taxpayer acquired two Target corporations by statutory merger. The activities of each Target corporation proved unprofitable, and after three to four years, taxpayer sold all of the assets of each Target corporation and liquidated the Target corporations pursuant to Section 332. *Id.*
- ▶ The taxpayer deducted the previously capitalized merger costs on its tax returns for the years in which the Target corporations were liquidated. *Id.*
- ▶ The court concluded that the taxpayer had a dual purpose for acquiring the Target corporations:
 - Raising capital; and
 - Purchasing the Target corporations.

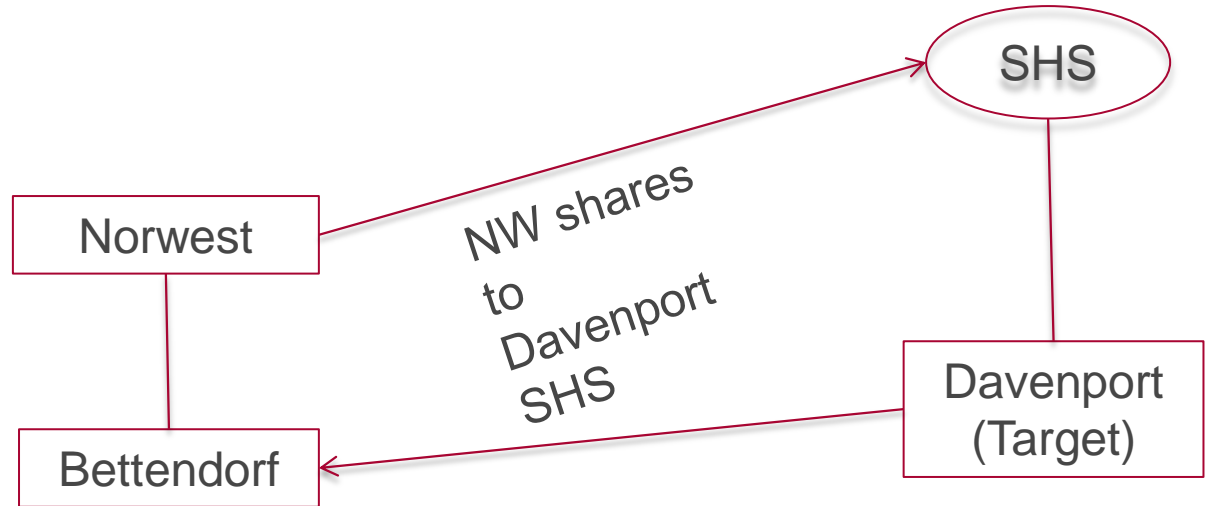
Vulcan materials co. v. U.S.

- ▶ In 1954 two corporations were merged into a third corporation, in Section 368(a)(1)(A) reorganizations. When the resulting corporation merged again in 1957, they deducted the costs associated with the 1954 mergers.
- ▶ Even though an “A” merger mechanically requires the Target company to liquidate, the Target company is succeeded to by the Acquiring company for federal income tax purposes and its business enterprise has not ceased.
- ▶ Held - capitalized costs associated with a prior merger are not recognized as liquidation costs upon a subsequent merger, but carry over and are associated with the ongoing business

Wells Fargo v. Commissioner, 224 f.3d 874 (8th Cir. 2000)

STEP ONE:
Bettendorf and
Davenport merged

STEP TWO: Norwest
issued 9,665,713
shares of its common
stock to the
Davenport SHS as
merger
consideration.



Wells Fargo v. Commissioner

- ▶ Tax Court held that \$150,000 of the salaries paid to Davenport's corporate officers (and \$111,270 paid to other attorneys) must be capitalized, rather than deducted fully during the year they were paid.

Wells Fargo v. Commissioner

- ▶ Transaction fees at issue were incurred by Davenport (Target)
 - L&W (law firm) – \$474,018
 - Officer Salaries - \$150,000 (amount of salary allocable to work done on the transaction)

Wells Fargo v. Commissioner

- ▶ Petitioner, Wells Fargo, (who subsequently acquired Norwest Bank) argued that certain of the L&W fees were improperly deducted and should have been allocated as follows:
 - \$83,450 – deduction for services related to investigating the products, services and reputation of Norwest, etc. that were rendered prior to the date the Davenport Board of Directors approved the merger
 - \$23,700 – deduction for due diligence services provided prior to OCC approval of merger
 - \$4,120 – deduction for services performed in connection with D & O liability coverage

Wells Fargo v. Commissioner

- ▶ The Eighth Circuit in applying the reasoning of Rev. Rul 99-23, concluded that \$150,000 of the officer salaries were deductible as ordinary and necessary expenses, and \$83,450 of the investigatory costs incurred prior to the board decision or the “bright line date” were deductible. The remaining legal fees were capitalized. *Id.*

Treas. Reg. Section 1.263(a)-5

- ▶ Regulations were issued in December 2003 to incorporate many of the concepts of case law and IRS rulings. The Regulations use terminology developed by the courts and IRS in prior authorities.
- ▶ It's important to remember, that without an allocation of transaction costs the default rule is capitalization.

Treas. Reg. Section 1.263(a)-5

▶ General Rule

- Taxpayers must capitalize costs paid to facilitate the following types of transactions
 - Asset acquisition of a trade or business
 - Acquisition of an ownership interest in a business entity if, immediately thereafter, the acquiring and target are related under 267(b) or 707(b)
 - An acquisition of an ownership interest in the taxpayer other than by a redemption or other purchase of taxpayer's equity by the taxpayer
 - A reorganization under Sections 368 or 355
 - A Section 351 or 721 transaction
 - A formation of a disregarded entity
 - An acquisition of capital
 - A stock issuance
 - A borrowing
 - Writing an option
 - Bankruptcy transactions

Treas. Reg. Section 1.263(a)-5

- ▶ General Rule
 - Facilitating includes investigatory and any activities otherwise pursuing the transaction
- ▶ Exceptions for investigatory costs for “covered transactions”
 - Taxable asset acquisition of trade or business
 - Taxable acquisition of an ownership interest in a business entity, if target and acquiring are related under 267(b) or 707(b)
 - A 368(a)(1)(A), (B), (C), or (D) reorganization

Documentation of Deductibility Positions- Treas. Reg. Section 1.263(a) - 5(e)(1)

- ▶ Generally, an amount paid by a taxpayer in the process of investigating or pursuing a covered transaction facilitates the transaction only if the amount relates to activities performed on or after the “bright-line” date, which is the earlier of:
 - the date on which a letter of intent, exclusivity agreement, or similar written communication (excluding confidentiality agreements) is executed by the parties; or
 - the date on which the material terms of the transaction (as tentatively agreed to) are authorized or approved by the taxpayer’s board of directors (or appropriate governing body).
 - If the transaction does not require approval from the board of directors, the date on which the parties execute a binding written contract reflecting the terms of the transaction shall be the date for this purpose.

Ordinary and Necessary in the Context of a Transaction

- ▶ Section 162(a) generally allows a current deduction for those ordinary and necessary business expenses incurred in a taxpayer's trade or business.
- ▶ A cost that is otherwise deductible may not be immediately deducted if it is a capital expenditure, which is a cost that yields future benefits to the taxpayer's business.
- ▶ Certain types of "transaction costs" have been carved out and can be treated as ordinary and necessary even if incurred in the context of a transaction.
 - Certain Employee Costs (*See, Treas. Reg. §1.263(a)-5(d)(2)*)
 - Routine Business Advice (*See, Ellis Banking Corp. v. Comm'r, 688 F.2d 1376, 1379 (11th Cir. 1982)*)
 - Payments in connection with complying with regulatory requirements (*See, CCA 201713010*)
 - Certain integration costs (*See, Treas. Reg. §1.263(a)-5(c)(6)*).

IRS Authority in Addressing Taxable Asset Mergers--Treas. Reg. Section 1.263(a)-5(g)(2)

▶ Taxable Acquisitions

- Acquiring Company

- In the case of an acquisition, merger or consolidation that is not described in Section 368, any amounts required to be capitalized under this section are added to the basis of the acquired assets, or to the stock if it is a stock acquisition
 - See also, Treas. Reg. §1.263(a)-5(l) Example 8

- Target Company

- Capitalized costs under this section are an offset to amount realized on the sale of Target's assets.

Allocation of Costs Incurred in a Taxable or Tax Free Asset Transfer-- Target Tax Consequences

- ▶ Taxable Asset Transfer—
 - Various Regulatory provisions treat costs incurred by a target company to “sell” its assets as an offset to proceeds, thus allowing for recovery immediately.
- ▶ Tax-Free Asset Transfer—
 - Case Law “implies” that the target company capitalizes the costs incurred to engage in the merger to some category that is related to enterprise value, which is associated with the business and continues until the business ceases. *See, INDOPCO.*

Allocation of Costs Incurred in a Taxable or Tax Free Transaction-- Acquiring Tax Consequences

- ▶ Taxable Asset Transfer—
 - Various Regulatory provisions support allocating the costs of acquiring the assets to such assets' tax bases in the hands of the acquiring company
- ▶ Tax Free Asset Transfer—
 - Case law supports the theory that the acquiring company capitalizes its costs of effectuating the merger and allocates the costs to the underlying business enterprise.
- ▶ Tax Free Merger—
 - It is not clear how to trade costs associated with a tax free merger.

What Information Must Typically Be Assembled and Reviewed to Support Transaction Cost Deductions?

- ▶ General Ledger Entries of Transaction Costs that are or will be listed on the general ledger of the Taxpayer.
- ▶ A Letter of Intent and/or Exclusivity Agreement, and/or a Confidentiality Agreement and the dates any of these documents were entered into by the parties.
- ▶ Execution copy of the Flow of Funds Memorandum, with wire transfers showing the date of payment of the invoices and the party designated as payor and payee.
- ▶ Details on the additions and subtractions to the working capital account that describes or lists which payments to specific service providers are to be made by the taxpayer on or after closing.

Information Needed

- ▶ Execution copies of any Acquisition Agreement, including schedules and any side-agreements.
- ▶ Debt Instruments created or modified as part of the transaction, including the terms of the finance costs.
- ▶ Engagement letters and Invoices from the identified service providers including accountants, lawyers, employment experts, bankers, IT firms.
- ▶ Any financial statements of the Taxpayer for the relevant time period covering the transaction.
- ▶ Any reports and structuring documents or step plans generated by due diligence or transaction planning teams as part of the investigatory activities of either the acquiring company or the target.

Information Needed

- ▶ Board of Director meeting minutes of the Taxpayer (including any presentations by outside service providers) reflecting key decisions and the dates of such decisions with respect to the transaction and/or payments to be made to service providers who assisted with the transaction.
- ▶ Statements from key management at either the acquiring company or target or both to verify and explain what the service providers were doing and when they were doing it (if such information is not clear from the invoices or other documents). For the one line invoices from lawyers or other service providers, name and contact information for a point person at each firm to discuss the scope of services.
- ▶ Documents indicating that certain fees paid by the Taxpayer were success based fees.

Allocation of Costs Between Transaction Participants

- ▶ Generally, one corporation's payment of another corporation's expense does not give rise to a trade or business deduction for the payor corporation.
 - *Interstate Transit Lines v. Comm'r*, 319 U.S. 590 (1943)
 - A corporation could not take a deduction for the operating deficit that it reimbursed to its subsidiary. *Id.* at 594.
- ▶ Such payments of another's obligations are not deductible as ordinary or necessary business expenses because they are not "ordinarily" incurred in the payor's trade or business.
 - *South Am. Gold & Platinum Co. v. Comm'r*, 8 T.C. 1297 (1947)
 - A parent holding company could not deduct legal expenses, incurred from negotiating and carrying out a settlement agreement on behalf of its subsidiaries where the subsidiaries acquired additional proprietary rights, as ordinary and necessary business expenses because these expenses were (1) not incurred in carrying out the parent company's business and (2) were made to hold or acquire capital assets. *Id.* at 1302.

Exception: The “Direct and Proximate Benefit” Test

- ▶ Courts apply the “direct and proximate benefit” test in determining whether one company’s payment or reimbursement of another company’s expense is deductible or properly taken into account by the paying or reimbursing company.
- ▶ To satisfy the threshold requirements of this test, the taxpayer must prove that the specific services or activities giving rise to the claimed deduction were performed for the taxpayer’s direct and proximate benefit.

Information Supporting Application of the Direct and Proximate Benefit Test

- ▶ A deduction may be available when
 - an expense directly relates to the taxpayer's business, and
 - the taxpayer pays or reimburses such expense.
- ▶ Facts and circumstances determination
- ▶ Requires extensive documentation, including, but not limited to:
 - Engagement letters for original work
 - Factual narrative describing the benefit of the services to the paying taxpayer
 - Factual discussion on how such services relate to the paying taxpayer's business and are not related to the investment aspects of the transaction
 - Transaction documents indicating who paid the fees and when such payments were made.

Priv. Ltr. Rul. 200830009 (July 25, 2008)

- ▶ Parent, Company (“Taxpayer”), Investor Group and Acquisition Co. were involved in a merger transaction through which Taxpayer was acquired by merging with Acquisition Co., with Taxpayer surviving.
- ▶ Fees related to this merger transaction included:
 - Parent arranged transaction services that were directly provided to and coordinated with Taxpayer.
 - Acquisition Co. incurred transaction costs including fees for financial advice, legal services, and due diligence services.
 - Taxpayer paid fees to secure debt financing; providers of such financial services were not engaged directly by Taxpayer.
 - Investor Group arranged underwriting services on behalf of Taxpayer as part of obtaining the debt financing and engaged other service providers on behalf Acquisition Co., the services of which directly benefitted Acquisition Co.

Priv. Ltr. Rul. 200830009

- ▶ Taxpayer requested permission to allocate the transaction costs based on which entities directly and proximately benefited from the services and paid or reimbursed the fees associated with these services.
- ▶ The IRS concluded that the Taxpayer could allocate transaction costs based upon the entity to which the services were rendered and/or on whose behalf the services were provided, despite the fact that the payor of such costs may not have been the original obligor.
 - Priv. Ltr. Rul. 200953014 (Sept. 15, 2009)
 - In facts similar to above, the IRS concluded that certain transaction costs arranged by one party to the transaction could be allocated to another party when the services were rendered for or on behalf of such other party.

Square D Co. v. Commissioner, 121 T.C. 168 (2003)

- ▶ Taxpayer was the target of a hostile takeover by Acquiring Corporation (“Acquiring”). *Id.* at 173.
- ▶ Acquiring specifically created a transitory subsidiary corporation (“ACQ”) to facilitate the acquisition of the Taxpayer, and agreed to pay loan commitment and legal fees on behalf of ACQ. *Id.* at 174.
 - In pursuing the acquisition, Acquiring (on behalf of ACQ) incurred legal fees and arranged a loan to fund the takeover and to provide operating capital thereafter. *Id.* at 175-77.
- ▶ After hostile negotiations, ACQ merged into the Taxpayer, with the Taxpayer surviving. *Id.* at 175.

Square D Co. v. Commissioner

- ▶ The Tax Court determined that Taxpayer received a direct benefit from the legal services, despite not being a party to the contract pursuant to which these services were provided, because these services were performed for the benefit of Taxpayer. *Id.* at 200.
- ▶ The Tax Court concluded that when acquisition costs are incurred on behalf of the subsidiary which merged with the Taxpayer (and thus, are incurred on behalf of the Taxpayer) and then paid by the Taxpayer, the Taxpayer may appropriately deduct the associated costs paid. *Id.* at 202.
- ▶ In other words, “a corporation may in certain circumstances deduct expenditures incurred on its behalf by a shareholder, where it makes a reimbursement.” *Id.* at 198.

Specialty Restaurants v. Commissioner, 63 T.C.M. (CCH) 2759

- ▶ Specialty (“Taxpayer”) opened restaurants as wholly owned subsidiaries and deducted expenses incurred in connection with the creation of each subsidiary as ordinary and necessary business expenses under Section 162. *Id.*
 - Included in these expenses were rent, interest, salaries and wages, travel to and from the site and training employee costs. *Id.*
- ▶ Commissioner disallowed these deductions and held the expenses to be preopening expenses capitalized under Section 263 or amortized under Section 195. *Id.*
 - Also, Commissioner categorized them as the respective subsidiaries’ expenses, not expenses of the Taxpayer. *Id.*

Specialty Restaurants v. Commissioner

- ▶ Taxpayer argued that expenses incurred in the creation of each subsidiary were an expansion of its existing business, and thus were its expenses. *Id.*
 - Section 162(a) generally allows a current deduction for ordinary and necessary business expenses paid or incurred in a taxable year in association with taxpayer's trade or business. *Id.*
- ▶ Commissioner maintained that the subsidiaries and Taxpayer were separate entities and must be taxed as such. *Id.*

Specialty Restaurants v. Commissioner

- ▶ The Court held:
 - Section 195 did not apply because Taxpayer did not elect to amortize such expenses.
 - The expenses, to the extent actual business operations commenced when such expenses were paid or incurred, would be properly deductible by the subsidiaries, not the Taxpayer. However, the Tax Court held that the expenses paid by the Taxpayer were capital contributions from the Taxpayer to the subsidiaries.
 - Further, the Tax Court held that the subsidiaries could not deduct these expenses because the trade or business requirement of Section 162 does not allow deductions for preopening expenses until a trade or business has begun to function and has performed activities for which it was organized. *Id.*
 - Thus, the expenses were not properly deductible by the subsidiaries under Section 162 because actual business operations had not commenced in the years that the deductions were claimed.

Paying Expenses of Another – Summary

- ▶ IRS rulings recognize the concept of one taxpayer’s ability to deduct costs originally incurred by another taxpayer, if the paying taxpayer can demonstrate how those costs benefit the taxpayer.
- ▶ In order to deduct costs under Section 162 they must be “ordinary and necessary” to the deducting taxpayer.
- ▶ Important to recognize the distinction between a Section 162 cost (business expansion) and a Section 195 cost (cost associated with a business start-up)
 - Both can include preliminary investigatory costs described in Treas. Reg. §1.263(a)-5(e)(1), i.e., certain costs incurred prior to the “bright line” date.

Success Based Fees -Treas. Reg. Section 1.263(a) - 5(f) Appropriate Documentary Evidence

- ▶ Documentation must be completed on or before the due date of the taxpayer's timely filed federal income tax return for the taxable year during which the transaction closed.
- ▶ Must consist of more than merely an allocation between activities that do and do not facilitate the transaction. Documentation must identify:
 - The various activities performed by each service provider;
 - The amount of each fee (or percentage of time) allocable to each of the various activities performed;
 - If date is relevant to determine whether an activity facilitated the transaction, the amount of each fee 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.

Documentation of Characterization of Success – Based Fees

- ▶ Tech. Adv. Mem. 20100236 (Sept. 21, 2009)
 - The IRS listed relevant information and documentation that supported a taxpayer's deduction of a portion of its success-based fees.
 - Relevant information and documentation included:
 - Investment banker presentation presented to Taxpayer
 - Retainer agreement.
 - Detail of out-of-pocket expenses.
 - Booklet prepared and presented by Investment Banker, which contained the agenda and outlined the process and the proposed timeline for the process for the "kick-off" meeting.
 - Letters to Parties to the transaction transmitting proposed timeline.
 - List of potential buyers.
 - Confidentiality Agreement.

TAM 20100236 – cont.

- Project working group list.
- Notes of certain employees and documentation of meetings with Parties to the transaction regarding certain representation and issues. Investment Banker presented at this meeting and prepared the presentation (along with Taxpayer) for the meeting. Information concerning a Fairness Opinion. This presentation was prepared and presented by Investment Banker, and was therefore a work product of Investment Banker.
- Data room information including disks containing all of the documents provided to potential suitors. Investment Banker reviewed and organized all of the various documents, provided and maintained hard copies, and maintained the master list of documents for the data room.
- "Confidential Booklet" prepared by Investment Banker and Taxpayer to send out to potential suitors introducing Taxpayer to targeted potential acquirers.
- Billing invoice, paid by Taxpayer, with no detailed breakdown of services rendered.

TAM 20100236 – cont.

- ▶ In the TAM, the taxpayer underwent an acquisition transaction and in the process of determining the benefits of the proposed transaction and ultimately entering into the transaction, the taxpayer incurred significant fees paid to various service providers, including fees paid only upon the successful closing of the transaction.
- ▶ The IRS addressed the issue of whether an allocation schedule prepared by a tax advisor that detailed and allocated certain success-based fees could qualify as “other records” under Treas. Reg. Section 1.263-5(a)-5(f).
- ▶ As listed above, the tax advisor’s allocation schedule was prepared using the detailed information listed in the TAM. These documents and the information provided to the IRS were contemporaneously assembled documents, and involved review and analysis by the tax advisor as to the nature of the services provided.

Rev. Proc. 2011-29, 2011-1 C.B. 746

- ▶ In order to resolve the intense factual document assembly and back and forth with the IRS as to the strength and sufficiency of documentation discussed above, Rev. Proc. 2011-29 provides a safe harbor election (the “Safe Harbor”) for allocating success-based fees between activities that facilitate a **covered transaction** (i.e., are capitalized) and activities that do not facilitate a **covered transaction** (i.e., are not capitalized).
 - “**Covered transactions**” mean business acquisitions or reorganizations under Treas. Reg. Section 1.263(a) – (5)(e)(3).
- ▶ An election pursuant to the Safe Harbor applies only to the transaction for which the election is made, and once such election is made, it is irrevocable.
 - The election applies to **all** success-based fees paid or incurred by the taxpayer for the transaction for which the election is made.
 - Each party to the transaction must make its own election – it’s a taxpayer election, not a transaction election.

Making the Safe Harbor Election

- ▶ If the Taxpayer intends to make the election under Rev. Proc. 2011-29, documentation must be assembled and statements must be made indicating that all of the “success-based” fees have been separately designated.
- ▶ The election is not valid if any of the success based fees are not included in the election form.
- ▶ The Taxpayer must also provide verification that the transaction is a “covered transaction” as defined in Treas. Reg. Section 1.263(a)-5(e)(3).
- ▶ The party making the election must be either the target or the acquiring company.
- ▶ Individual shareholders cannot make the election.

If Safe Harbor Election is Not Made Taxpayers are Subject to the General Documentation Rules

- ▶ ILM 201830011 (June 21, 2018)
 - In the ILM the Taxpayer deducted 92% of its success-based fees and used as its support for this allocation, a 2-page letter from the success-based service provider, its investment banker (IB).
 - The safe harbor election of 2011-29 was not made.
 - In exam, the IRS disallowed the deduction of 92% of the success-based fees because the IB letter was not sufficient documentation under Treas. Reg. Section 1.263(a)-5(f). Significant required documentation and information was missing from the 2-page letter, and a PowerPoint presentation provided by the Taxpayer after the exam began. Including:
 - Names, address and roles of each of the professionals working on the transaction,
 - Other records that support the amount of the fee allocated to each identified activity performed by the service provider.

ILM 201830011

- ▶ In addition, the IB letter that was provided had significant caveats that stated the percentage allocations were estimates and that the IB did not keep detailed time records. While the letter indicated that team members involved in the transaction were interviewed in preparing the percentage allocations, no information was provided on who those professionals were, the timing of their services, details with respect to their services, or their area of expertise or role in the transaction.
- ▶ As a result of the lack of documentation, the IRS denied the entire deduction and the Taxpayer was required to capitalize the costs.
- ▶ NOTE: This harsh result is a cautionary tale for taxpayers who choose not to elect the safe harbor—the IRS is apparently requiring taxpayers to once again assemble the voluminous documentation that was required prior to the issuance of Rev. Proc. 2011-29.

IRS Guidance on Eligibility for Safe Harbor Election

- ▶ As noted, Rev. Proc. 2011-29 applies only to transactions that are covered transactions as defined in Treas. Reg. Section 1.263(a)-5(e)(3) and allows taxpayers to elect to treat 70 percent of the success-based fees paid or incurred by the taxpayer in taxable years ended on or after April 8, 2011 as amounts that do not facilitate a transaction under Treas. Reg. Section 1.263(a)-5 while requiring that the remaining 30 percent of the success-based fees be capitalized.
- ▶ Since the issuance of Rev. Proc. 2011-29, the IRS has provided guidance in interpreting various components of the safe harbor and specifically, in what situations is a Taxpayer allowed to make the election.

No Election Permitted in Certain Transactions -CCM 201234027

- ▶ Though offset from the total amount of a success-based fee, the nonrefundable milestone payments were not contingent on the successful closing of the transaction but instead were guaranteed payments incurred upon the occurrence of specified milestones or upon some other date or event.
- ▶ Because the nonrefundable milestone payments made to a service provider for activities performed with respect to a covered transaction are not, themselves, success-based fees, they do not qualify for the Safe Harbor provided in Rev. Proc. 2011-29.
- ▶ However, taxpayer may make a Safe Harbor election to allocate the remaining \$8 million payable as a success-based fee.

No Election Permitted - CCA 201624021

- ▶ *CCA 201624021 (July 8, 2015)*
 - Taxpayer, an S-Corporation target corporation, sought to elect the safe harbor for success based fees incurred in a transaction in which they elected under Section 338(h)(10) to treat a stock sale as a deemed asset sale.
 - The Service stated that “[w]ith regard to an acquired taxpayer in an asset acquisition, the transaction is not a ‘covered transaction’ under Treas. Reg. § 1.263(a)-5(e)(3)”.

Eligibility for Safe Harbor Election

- In denying the ability of the target corporation to make the safe harbor election, the Service focused on the language of the covered transaction rule in Treas. Reg. § 1.263(a)-5(e)(3)(i) that “uses the phrase ‘taxable acquisition *by the taxpayer,*’” (*emphasis in original*) and found that in the present case, the “taxpayer” did not make a taxable acquisition.
- Here the taxpayer attempting to make the safe harbor election was the seller of the assets, not the buyer. The Service did acknowledge that the taxpayer could perform a traditional analysis with respect to its transaction costs and if consistent with its facts, could document that a portion of the success based fees at issue were properly deductible.

What if you “miss” the safe-harbor election?

- ▶ Reg. § 301.9100-3 – Ruling Request
- ▶ Private letter ruling request
- ▶ Current user fee is \$10,000
- ▶ To obtain relief, a taxpayer must show—
- ▶ It acted reasonably and in good faith;
- ▶ Requests relief prior to discovery by IRS of taxpayer’s failure to make the regulatory election;
- ▶ Failure to make the election due to events beyond the taxpayer’s control;
- ▶ Was unaware of the election (assuming taxpayer exercised reasonable diligence);

9100 Relief for missed elections

- ▶ Reasonably relied on written advice from IRS; or
- ▶ Reasonably relied on qualified professional and professional failed to make or advise taxpayer to make the election
- ▶ Granting relief would not prejudice the interest of the government
- ▶ Taxpayer's aggregate tax liability would be lower for all years to which election applies than if election had been made timely (taking into account time value of money)
- ▶ Several recent IRS Rulings allowing additional time to file the safe harbor election—
 - For example, see, *PLR 201711003*, *PLR 201544013*, *PLR 201516012*, *PLR 201338108*

TCJA – Potential Impact on Transaction Costs

- ▶ Asset purchases can be viewed more favorably under the TCJA because of immediate expensing. – Note: In an asset sale by a Target company, the safe harbor election for success-based fees cannot be made. Buyers can still make the election if the asset acquisition is an acquisition of a trade or business.
- ▶ Because NOLS are not “fully” available to offset income in tax years after the effect of TCJA, the “value” of the NOLs generated by a deduction of transaction costs might be viewed as less valuable.

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- ▶ Has more than 25 years' experience providing large and mid-size corporate clients advice in corporate tax matters
- ▶ Previously worked for the National Tax Group of Ernst & Young, LLP, where she was a national tax partner and director of M&A tax services for the mid-Atlantic area
- ▶ Started career as attorney-adviser in the Office of Chief Counsel (Corporate) of the Internal Revenue Service (1990 to 1994)



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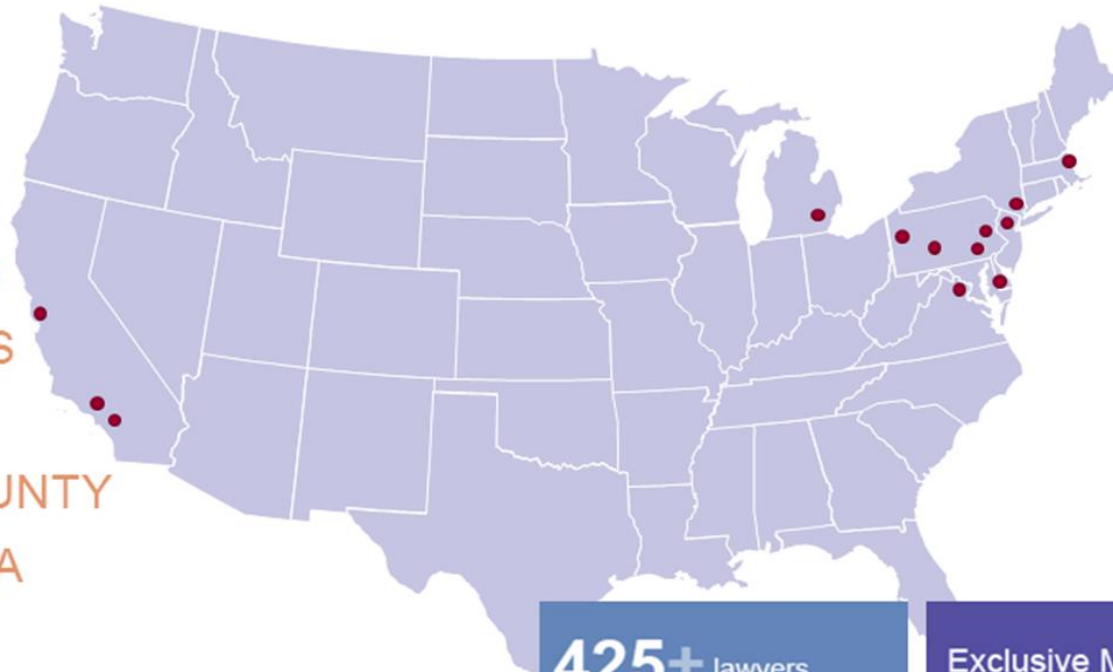
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